Dimension 1: Evaluate Client Industry, Markets and Competitors
Purpose of Dimension 1

The purpose of Dimension 1 is to provide tools and insights to support evaluation of a client’s industry, markets and competitors.

Key topics in this Dimension are:

• Evaluating the Client’s Industry
• Industry/product life cycles
• Industry risks
• Characteristics of key industry sectors
• Evaluating the Client’s Market
• Buyer/supplier profiles
• Buyer/supplier concentrations
• Entry/exit costs
• Vulnerability to substitution
• Evaluating Competition in the Client’s Market
• Profiling market competitors
• Putting competition in the context of the market
Evaluating the Client’s Industry

Understanding the industry within which a company operates is key to understanding the total risk in lending to that company. The objective of this section of Dimension 1 is to provide insights to help you answer the question: “Does the company have a business strategy that makes sense within the context of general industry characteristics and economic trends?”

The three topics included in this discussion are:

- Industry/product life cycles
- Industry risks
- Characteristics of key industry sectors

Industry/Product Life Cycles

In addition to general industry characteristics, businesses are affected by industry and product life cycles. As new industries emerge or as new products are introduced, some will gain acceptance and others will not. Over time, sales for a successful product will grow, then level off, and eventually decline. Industries, companies, and products all have life cycles. You can recognize stages of product life cycles in the sales of such diverse products as light pickup trucks and minivans, personal computers, toys, and cassette tapes.

Product life cycles are influenced by demand for a product (however derived) and by the elasticity or inelasticity of that demand. Demand is simply defined as the need or desire for the sellers’ goods and services. Inelastic demand occurs when price is of little concern to the customer; therefore, a change in price has little effect on the demand for the product. When demand is elastic, a change in price results in a proportionate change in the quantity of the product or service demanded.

As products and services mature, they tend to become more price-sensitive (demand becomes more elastic). This flattening of the demand curve is part of the natural life cycle of a product and another way to understand the profit decline for mature-stage products, companies or industries.

The same product life cycle concept of emerging, growth, maturity, and decline can be applied to businesses and entire industries.

When evaluating companies, you should remember that:

- Optimistic sales and profit projections may not materialize from a company whose products or industry are in the growth stage as new competitors may be able to rapidly and inexpensively enter the market.

- When a company has diversified to the point at which it has multiple products and services, it is prudent to analyze each product line’s life cycle stage before underwriting and documenting a loan.

- When a company’s success depends on a single product or service, understanding its life cycle is critical to how you structure a repayment schedule before sales and cash flows are reduced or exhausted.
• Inelastic demand can be an advantage because the company is able to more easily raise prices to cover costs and create more profits. In many cases inelastic demand doesn’t last very long, because of increased competition, sudden decrease in demand, or because a substitute for the product or service has been created.

In this discussion, we will cover the following life cycle stages:

**Emerging Stage**

Total sales are very low, consumer acceptability is uncertain, and cash flow is probably not sufficient to cover start-up costs and the fixed costs of production or providing the service.

**Growth Stage**

If the product has gained market acceptance, sales build rapidly and profits can be very attractive, until other competitors enter the market.

**Mature Stage**

Profitability peaks, flattens out, and then begins to decline because other companies have successfully entered the market. One company’s early success in a market is often due to its dominant market share, which may be reinforced and sustained by a patent, copyright, or secret formula. Competitors are attracted by the sales and profit success of early entrants and the success of these new competitors is related to ease of entry into the market. Competition tends to drive prices down, especially if demand for the product at higher price levels has been satisfied.

**Declining Stage**

Consumer demand for the product declines and sales fall. Profits fall when sales can no longer cover the fixed costs or the company lowers prices in an attempt to maintain sales levels. However, there are substantial profit opportunities in this stage for a limited number of well-managed companies selling to a reduced, but stable, customer base.

**Emerging Stage**

Companies in the introductory or emerging stage often need large amounts of capital to sustain them through long periods of research, product development and test marketing. After the product has been developed, test marketed, and is ready for rollout, additional funds are needed to support advertising and marketing expenses in order to educate the consumer and gain market acceptance. Because of the uncertainty of success, owners of companies and venture capitalists usually supply such capital. This is especially true in companies with one or just a few products, all of which are at the same stage of development. In addition, emerging companies generally possess entrepreneurial management and may lack experienced management in all of the core competencies needed to operate a company.

Financial products and services required by companies in the emerging stage include:

• Equity type financing (venture capital, private placement, etc.) due to the high cash needs and limited demonstrated debt repayment ability.

• Subordinated debt, preferred or common stock, or other sources of long-term capital.
• For very small businesses, the owners’ personal borrowings (such as home equity loans) may provide adequate initial long-term capital.

• Typical liabilities found on the emerging company’s balance sheet include accrued expenses, accounts payable, lines of credit (generally if guaranteed by a sponsor) and perhaps real estate loans (with sponsor support).

The following chart summarizes the strengths of an industry or product in the emerging stage, along with some of the relevant risks.

<table>
<thead>
<tr>
<th>LIFE CYCLE STAGE</th>
<th>POSSIBLE STRENGTHS</th>
<th>RISKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging:</td>
<td>High sales due to product introduction and unique positioning</td>
<td>Failure— the failure rate for new products is high— some gain acceptance only after modification from their original form</td>
</tr>
<tr>
<td></td>
<td>Little competition</td>
<td>Production capacity— either under or over capacity as demand varies substantially from projections</td>
</tr>
<tr>
<td></td>
<td>High prices and gross margins (as result of little competition)</td>
<td>Low net margins because of high R&amp;D and marketing costs</td>
</tr>
<tr>
<td></td>
<td>Registration of patents and intellectual property rights to create barriers of entry to competitors</td>
<td>Initial mismatch of cash flows</td>
</tr>
<tr>
<td></td>
<td>Able to develop brand loyalty</td>
<td>Initial product quality may be poor dictating the need for expensive changes to the product design or formulation</td>
</tr>
</tbody>
</table>

GROWTH STAGE

Companies with products in the growth stage may show rapid sales growth and strong profitability. Often companies project that this growth and profitability will continue and commit to major production expansions, only to find that they have shrinking sales or lower profits or both. At the outset of the growth stage, demand may allow for creation of additional capacity and competitors. But as the industry’s sales begin to grow at a slower rate and then peak along with increased competition, only the strongest companies survive. Lending to growth-stage companies requires very careful judgment of the critical factors that will help
the company succeed over its competition and how management will meet these competitive challenges.

Financial products and services required by companies in the growth stage may include:

- Cash Management services
- Revolving lines of credit to finance growing working capital assets
- Long-term debt to finance fixed asset growth associated with increased production capacity
- Export financing if international in nature
- Mortgage loans to finance real estate needs

The following chart summarizes the strengths of an industry or product in the growth stage, along with some of the relevant risks.
### GROWTH STAGE CHARACTERISTICS

<table>
<thead>
<tr>
<th>LIFE CYCLE STAGE</th>
<th>POSSIBLE STRENGTHS</th>
<th>RISKS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Growth:</strong></td>
<td>- Increasing demand and high selling prices as product acceptance leads to growth in demand</td>
<td>- Increasing competition, depending upon the cost of entry</td>
</tr>
<tr>
<td></td>
<td>- Product quality improved as a result of changes made in the emerging stage</td>
<td>- Optimistic sales and profit projections may not materialize because new competitors enter the market</td>
</tr>
<tr>
<td></td>
<td>- Higher net margins than competitors still in the emerging stage</td>
<td>- Production over-capacity due to increased competition</td>
</tr>
<tr>
<td></td>
<td>- Expansion and solidification of significant brand loyalty</td>
<td>- High marketing costs relating to increasing market share and product differentiation strategies</td>
</tr>
<tr>
<td></td>
<td>- Development of compatible products with high margins</td>
<td>- Sales may outstrip company’s capital base, putting additional requirements on external funding sources</td>
</tr>
</tbody>
</table>

### MATURE STAGE

Companies in mature industries or with mature products/services may ultimately have lower gross profit margins than they enjoyed in the growth stage but, because of stable demand, their cash flow for debt service may be stronger and their likelihood for continued success is more predictable. They have weathered the trials of tough competition and are marketing proven products or services. Mature-stage companies are usually less risky loan candidates, especially those requiring shorter-term credit facilities.

Financial products and services required by companies in the mature stage may include:

- Cash Management services
- Revolving lines of credit to finance working capital assets
- Long-term fixed asset financing for equipment and other capital expenditures
- Export financing if international in nature
- Mortgage loans to finance real estate needs
The chart below summarizes the strengths of an industry or product in the mature stage, along with some of the relevant risks.
### MATURE STAGE CHARACTERISTICS

<table>
<thead>
<tr>
<th>LIFE CYCLE STAGE</th>
<th>POSSIBLE STRENGTHS</th>
<th>RISKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mature:</td>
<td>• Price stability at some level</td>
<td>• Declining profits caused by:</td>
</tr>
<tr>
<td></td>
<td>• Superior quality</td>
<td>➢ Demand levels off and begins slow decline, leading to market share contraction for existing companies</td>
</tr>
<tr>
<td></td>
<td>• Maximum brand/product loyalty achieved</td>
<td>➢ A few low cost producers enter the market</td>
</tr>
<tr>
<td></td>
<td>• Product enhancements (real or perceived) developed to extend product life</td>
<td>➢ Competition is maximized; products begin to become more price sensitive and demand more elastic, forcing companies to lower selling prices</td>
</tr>
<tr>
<td></td>
<td></td>
<td>➢ Production over-capacity likely; OEM’s (Original Equipment Manufacturers) likely to invade after-market in order to use idle plant capacity</td>
</tr>
</tbody>
</table>

### DECLINING STAGE

Companies in declining industries or with declining products may still be suitable borrowers, particularly for seasonal or short-term loans not dependent on long-term economic success. Either companies have failed to develop new products or lines of business, or they are in industries in which the demand for the product or service is in absolute decline. Sometimes the demand for the product or service is fading very rapidly or so gradually that it is difficult to notice.

Financial products and services required by companies in the declining stage may include:

- Cash Management services
- Revolving lines of credit to finance working capital assets
- Long-term debt to finance fixed asset repair or replacement
- Export financing if international in nature
- Mortgage loans to finance real estate needs
- Trust and Wealth Management services
The chart below summarizes the strengths and risks of an industry or product in the declining stage.
<table>
<thead>
<tr>
<th>DECLINING STAGE CHARACTERISTICS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LIFE CYCLE STAGE</strong></td>
</tr>
<tr>
<td>------------------------</td>
</tr>
<tr>
<td>Decline:</td>
</tr>
<tr>
<td>Sales drop as demand falls. Unless innovation occurs, the industry will shrink and perhaps ultimately fail</td>
</tr>
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**Industry Risks**

Different industries have very specific risks, but they are also subject to generic risks that affect all industries, albeit in different ways. In this section we will analyze the risks that each company faces within the context of its industry and business strategy. We will examine the following issues:

**Macroeconomic Issues**

The extent to which an industry is affected by regulatory, economic, political and public events, as well as labor and environmental issues.

**Cyclicality**

The extent to which an industry is affected by economic or business cycles.

**Seasonality**

The extent to which an industry is affected by normal changes in climate or calendar specific buying patterns.
Technology Risks

The extent to which technology has improved people/production efficiencies, but also has created new types of risk.

Life Cycle Stage

The extent to which the industry is affected by its stage in the life cycle.

International Considerations

The extent to which this industry is affected by international events.

Business Process and Product Risks

The extent to which industry characteristics influence a customer’s business processes, practices, and products.

MACROECONOMIC ISSUES

Most companies are challenged by many of these macroeconomic issues at one time or another during their life cycle.

The direct and indirect impact of these macroeconomic issues is ultimately reflected in your customer’s financial statements. It is worthwhile to discuss these macroeconomic issues with management and examine them for existing or potential problems that could impact their repayment ability.

Regulations

All companies face regulatory guidelines. Find out which regulations affect your customer and how they impact the company’s financial performance.

In assessing the financial effect of regulations, know the cost of compliance and risk of noncompliance. Fines associated with “out-of-compliance-conditions” or outright noncompliance can be significant.

Regulations that require initial licensing and ongoing recertifications can raise the cost of doing business.

Environmental Regulations

All companies face the impact of this particular group of regulations. At some point in the supply chain for the production of a product, environmental costs will be felt. You need to assess which environmental regulations directly affect your customer.

The liability for clean-up costs and fines for noncompliance could alter the financial health of your customer. Most financial institutions require a review of the environmental regulations that affect specific customers at origination and during the life of the transaction.

Additionally, most loan documentation requires an environmental certificate signed by an officer of the company attesting to the firm’s compliance with applicable environmental regulations. In some cases, your institution, as a lender to the company, can become liable for environmental infractions. You should enlist legal and environmental expert assistance when documenting a loan to a company with known or perceived environmental problems.
Changing Interest Rates

All companies are affected by changes in interest rates, if not directly then through their effect on customers and suppliers. Interest rates can raise or lower operating expenses, and, as a result, raise or lower profits.

Doing a mental calculation using total interest expense and interest rates (or blended rates), you can determine approximate average principal amount of debt outstanding during the accounting period and compare that number to the ending period debt balance. This comparison will allow you to estimate a company’s interim period borrowing requirements.

Labor

Companies face challenges in attracting qualified people while at the same time maintaining product or service quality.

There has been a big change in how people work (flex-hours, job sharing, etc.) and what they expect from their employers. The issues that employers face from labor laws, changes in work ethics, labor union contracts, and essential skill shortages can be expensive and fraught with potential liability.

Political and Public Opinion

Some companies may escape this issue, only because they, for one reason or another, do not appear on the radar screen of some political body or public advocacy group. The problem with this area is that very often your customer does not control the impact or timing of its exposure to these issues.

While issues in this category can be expensive in terms of settlements, sometimes the larger problem becomes the disruption in the execution of the day-to-day business plan and the allocation of people and financial resources.

These issues often arise when your customer wants to expand their business and they must get variances from code in the case of real estate or approval from existing labor pools before moving ahead. All of these groups have “agendas” that can be far different from the operating strategy of your customer.

Weather

As an economic force, weather becomes apparent many times only in the form of a catastrophe such as a drought, hurricane, blizzard, hard freezes, fire, disease, etc. Unfortunately, with the movement to “mega” businesses as companies consolidate, if a natural disaster strikes at just the right place, it can be devastating to your customer. The disaster doesn’t even have to have a direct effect on your client, but only has to affect one company in the supply chain for problems to occur.

Some of these weather issues, such as business disruption, and fixed asset replacement, can be insured against. However many of the consequences from such a disaster can permanently affect the future viability of your customer, especially if a significant time disruption occurs in the production cycle.

Currency Fluctuations

With the worldwide economy firmly in place, there is the potential for substantial changes in currency valuations. The risk is more than the extreme event of a country’s unexpected currency devaluation. The risk is that day-to-day volatility in the world currency markets can
affect the profitability and potential repayment ability of your customer, if not properly hedged.

Not only is there the currency risk, but if inexperienced financial managers address the risk, the risk can be compounded considerably. If your customer is dealing directly with international clients, it is prudent for you to assess their ability to manage their foreign currency risk; an opportunity may exist for your institution’s international department!

**Cyclicality**

Cyclicality refers to the extent to which an industry is affected by the expansion and contraction in economic cycles, often referred to as business cycles. There is much debate as to whether business cycles are repeatable with similar economic dynamics. Economists agree that there are often similarities between business cycles and what instigates change, but they also agree that each business cycle has its own set of economic traits. Defining the business cycle is not easy in today’s economy. As a lender, you should understand the principles of expansion and contraction in the market place and how these movements affect your customer. You should investigate your customer’s strategic approach to counter-cyclicality, i.e. having products and services that are marketed to the “other side” of the business cycle. This is an especially important concept to grasp when considering long-term loans to fund expansion or fixed asset replacements.

While economists disagree on the definition and early warning signals for the onset of a change in the business cycle, it is best for you to talk with your customer and other companies in a particular industry. Management of these firms, and their industry associations, often have an “ear to the ground” and know what is happening in the marketplace and where the industry stands in the business cycle. Using an intellectual barometer for business cycle movement is sometimes not as meaningful as talking with people who have an intimate and historic knowledge of the industry and vision as to how the past can be used to forecast the future for the industry.

**Evaluating Cyclical Risk**

Evaluating the risk that cyclicality poses to a particular business involves assessing:

- How vulnerable the company and its industry are to a business cycle, i.e. changes in the economy into which the company markets its products or services. Not all industries react the same way or at the same time to changes in the continuum of economic cycles. How have the company and industry withstood the impact of previous business cycles?

- Whether the financial condition of a company is strong enough to withstand the possible negative effects of a downturn in the business cycle or has enough capital to take advantage of opportunities as economic growth occurs.

- The quality of the business’s plan for dealing with economic cyclicality and its ability to insulate itself from extreme economic swings through thoughtful management.
# Stages of the Business Cycle

Understanding how each stage in the business cycle impacts your customer's borrowing requirements is important to your assessment of risk. The following chart helps frame risks by showing the characteristics and resulting effects on a business in each stage of a general business cycle:

<table>
<thead>
<tr>
<th>STAGES OF THE BUSINESS CYCLE</th>
<th>CHARACTERISTICS</th>
<th>EFFECTS ON BUSINESS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Early Expansion Stage</strong></td>
<td>• Interest rates relatively low</td>
<td>• Sales and profits usually increase</td>
</tr>
<tr>
<td></td>
<td>• Consumer and business credit are plentiful</td>
<td>• Companies often expand production facilities, increase inventories, add employees, start new business lines, and/or introduce new products</td>
</tr>
<tr>
<td></td>
<td>• Consumers have good levels of disposable income because of secure jobs, increasing wages, and available credit</td>
<td></td>
</tr>
<tr>
<td><strong>Late Expansion Stage</strong></td>
<td>• Consumer and business spending and demand for credit increase, pushing up interest rates and prices</td>
<td>• Sales stabilize or begin to decline as the higher cost of credit and of goods and services begins to dampen consumer spending and business expansion</td>
</tr>
<tr>
<td></td>
<td>• Capacity utilization climbs and prices stabilize for goods and services</td>
<td></td>
</tr>
<tr>
<td><strong>Early Contraction Stage</strong></td>
<td>• Optimism about the future decreases as interest rates and prices remain high</td>
<td>• Fewer new products are developed or additions to capacity are begun and less production capacity is brought on line</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Less credit is demanded as companies seek to reduce reliance on debt and increase liquidity</td>
</tr>
<tr>
<td><strong>Late Contraction Stage</strong></td>
<td>• Economy slows down</td>
<td>• As demands for goods and services shrink, businesses begin to see new opportunities for growth. Falling prices and increased availability of credit set the stage for a new expansion stage.</td>
</tr>
<tr>
<td></td>
<td>• Unemployment increases</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Interest rates gradually fall</td>
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</tbody>
</table>
**Seasonality**

Without the influences of natural disasters, major alterations in weather patterns or sudden changes in consumer purchasing habits, the effects of seasonality on a business may be reasonably predictable, and provide your customers with profit making opportunities.

**What Makes A Business Seasonal?**

- Weather—Traditional seasons of spring, summer, fall, and winter
- Calendar-dictated seasons
- Religious, cultural, and national holidays
- Other industries’ annual business cycles, including things such as back to school and income tax deadlines.

These seasonal influences cause cash receipts to temporarily decline and cash disbursements to temporarily increase and vice versa. In a normal season, these variations in the cash flow cycle can be anticipated and even taken advantage of by your customer.

**Effects of Seasonality on Cash Requirements**

Seasonality can alter cash requirements in two ways:

- By temporarily lengthening the cash cycle
- By increasing daily average sales or cost of sales

**Types of Seasonality**

<table>
<thead>
<tr>
<th>SEASONALITY TYPES &amp; CHARACTERISTICS</th>
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<tbody>
<tr>
<td><strong>TYPES</strong></td>
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<tr>
<td><strong>Seasonal sales</strong></td>
</tr>
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<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td><strong>Seasonal cash</strong></td>
</tr>
<tr>
<td>Disbursements that lengthen the cash cycle.</td>
</tr>
</tbody>
</table>
SEASONALITY TYPES & CHARACTERISTICS

<table>
<thead>
<tr>
<th>TYPES</th>
<th>CHARACTERISTICS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable may have extended payment terms including datings, which result in a significant source of funding.</td>
<td></td>
</tr>
<tr>
<td>If receivables or inventory grow faster than sales (such as during inventory buildup), the cash cycle can lengthen and the demand for cash be more severe than expected.</td>
<td></td>
</tr>
<tr>
<td>Higher daily sales cause a spike in cash needs for funding higher levels of working capital assets even if the length of the cash cycle does not change.</td>
<td></td>
</tr>
</tbody>
</table>

Seasonal cash
Receipts that lengthen the cash cycle. This is the least common type of seasonality.

Accounts receivable don’t get paid until your customer’s customer gets paid such as:

- Suppliers to government agencies may not be paid until the agency receives funding allocations.
- Suppliers to educational institutions are often not paid until after the students pay tuition.
- Suppliers to farmers may not be paid until crops are harvested and sold.

Tools for Identifying Seasonal Patterns and Determining Their Cash Flow Effects

- Interim (quarterly or monthly) Financial Statements.

Annual financial statements may not reveal the existence or effects of seasonality. Interim financial statements offer the advantage of showing how sales fluctuate during the year and how working capital assets have been affected. Using historical performance as one guide, you can estimate future seasonal borrowing requirements. Interim financial statements are especially helpful when:

- You want to determine if a company is truly seasonal from a cash cycle perspective.
- You want to estimate the future seasonal funding needs of a company.
- You have made a seasonal or long-term loan to a company, and you wish to follow the company’s progress (and your loan’s quality) more often than annually. Such monitoring is especially important when the company is new, growing rapidly or undergoing significant change in its marketing strategy.

Because interim statements are usually company prepared and not audited, they are subject to reporting errors that might be detected in a full audit, such as the verification of physical inventory. Comparing interim financial statements for the same period in prior years will help you get comfortable with the quality of the information.
Cash Budgets that project actual receipts and disbursements on a monthly basis can be helpful in structuring loans that meet the company’s borrowing needs. Cash budgets trace the movement of cash into a business, as customers pay for goods and services, and movement out of a business, as the company pays its suppliers, employees, shareholders, and lenders. Cash budgets differ from, but can be reconciled to, interim financial statements in two ways:

- Cash budgets describe the cash effect of events during a period and the balance sheet describes the cash condition at the end of a period. The cash budget and the balance sheet both show the cash balance at the beginning and end of any period (interim or fiscal).
- Both cash budgets and income statements describe events during a period, but the cash budget does so on a cash basis and the income statement does so on an accrual basis.

**TECHNOLOGY RISKS**

Technology has allowed companies to increase staff efficiency and reduce personnel costs per unit sold or service provided as companies have grown.

The risks associated with technological advancement are as follows:

- Are there substantial costs to be incurred in the initial purchase of hardware and software?
- Will there be disruption to the company’s workflow during system upgrades or conversions?
- Is the system “user friendly?”
- Does your customer have a labor force that possesses the necessary skills to run the system or will time and financial resources have to be spent to bring the workforce “up to speed?”
- How will the end-user be affected by system modification? How compatible is a system modification with any existing programs or systems that your customer may be utilizing in its operation?
- What kinds of system support risks are in existence after the system has been installed, and how financially stable is the support entity?

**LIFE CYCLE STAGE**

Understanding the position of the industry in the life cycle is important to identifying the types of risk the company will encounter. Earlier in this section we presented a detailed analysis of life cycle stages.

**INTERNATIONAL CONSIDERATIONS**

If your customer is a supplier to, or purchaser from, the international community, economic risk issues become compounded by political and cultural factors.

Consider the following international economic issues as they relate to your client:

- Currency valuations and exchange rates
• Raw material availability
• Labor force stability and costs
• Distribution channels in and out of the country
• Foreign competition
• Export/import tariffs
• Import/export balance of trade for that particular country
• Overall economic growth of the country

Given a stable political environment, probably the most common risk is that of currency fluctuations. This risk, if thoroughly understood by you and your customer, can be mitigated quite successfully by utilizing hedging techniques such as purchasing futures/options contracts in the local currency.

The political and cultural risks relate to the stability of the government and the relative impact of various cultural attitudes within the country.

Some of the international political and cultural issues to consider are:

• Work rules, skill availability, and ethics
• Foreign corporate ownership structure
• Country-specific regulations including environmental regulations
• Openness to foreign investment and threat of nationalization of foreign businesses
• Language difficulties
• Religious influence
• Political relations with the country where your customer/supplier is domiciled

Letters of credit and foreign exchange are two products that you can use to help your customers manage some of those international risks.

**BUSINESS PROCESS AND PRODUCT RISKS**

Many characteristics common to an entire industry can have particular influence on a customer’s business processes, practices, and products. Significant industry factors that introduce business-level risks include:

**Labor Relations and Supply Risks**

How vulnerable is your customer to interruptions in labor supply, for both production and administrative support staff?
**Distribution Risks**
- What are your customer’s distribution channels and what are some of the distribution system risks?

**Product and Service Risk**
- How does the development and marketing of the company’s products and services affect its life cycle stage?

**Production Risks**
- What impact do the complexities of the production cycle have on the overall business operation? In response, how has the customer configured its operations and facilities?

**Technology Risks**
- What technology strategies does the company employ and how are they funded, implemented and embraced by the employees?

**Intellectual Property Risks**
- What is the risk of loss of value or of control over the company’s intellectual property, and how effectively does the company protect itself against misuse, or allegations of misuse, of other parties’ intellectual property?

**Outsourcing Risks**
- How does your customer’s outsourcing strategy affect its risk profile, particularly if it is a large user of "outsourcing" or outsources a critical function?

**Other Risks**
- What other issues might affect your customer and how can you capture these issues?

**Labor Relations and Supply Risks**
Access to a skilled, affordable and uninterrupted labor supply is a key business requirement for many companies. We commonly think of manufacturing labor when considering labor relations and supply constraints, but the risks can be equally significant for management and non-manufacturing employees. In some industries, labor supply can be a life threatening risk to companies. For example, in the truckload sector of for-hire trucking companies, driver shortages are chronic and driver turnover commonly ranges between 90% and 120% per year. Companies in this segment of trucking are obligated to spend significant dollars for driver recruitment, and the most successful companies are often those that develop innovative driver retention programs, not necessarily geared just to monetary compensation. To find out if your customer is at particular risk for labor interruptions, ask the following questions:
- In which part(s) of company operations is there a significant risk of qualified labor shortage?
• What are the particular challenges that make it difficult to find qualified employees, such as highly specialized skills, chronic shortages that have created bidding wars for employees, etc.?

• Does organized labor influence your hiring and compensation practices either directly (union contract) or indirectly (union has influenced wage base and employment practices in the industry)?

• What has been the company’s employee turnover experience in the past three years?

• What special recruitment, training and retention programs has the company used to attract desirable employees? How do those programs differ from the competition?

• How does the company describe the quality of its labor relations? How does it measure the quality of its labor relations?

• What strategies is the company pursuing to lower its dependence on scarce labor, such as an outsourcing strategy or an automation strategy?

**Distribution Risks**

The issue here is very simple: who has direct contact with the customer? If your company is interfacing directly with the end-user, then it controls the fate of the customer relationship. If your customer is either a manufacturer or a wholesaler, then it may not be interfacing directly with the consumer or end-user and has to rely on a distribution system: wholesaler, broker, manufacturer’s representative, and retailer. The following issues should be reviewed:

• The exact relationship between your customer and the ultimate consumer of the company’s product or service.

• You can establish the points of risk in the distribution system and quantify them in terms of net sales, gross profits, and operating profits.

• Where can the breakdown in the distribution system occur and who controls its resolution?

All parts of the distribution system need to have a set implementation strategy as well as a backup plan, especially for those parts not controlled within your customer’s operating infrastructure. An independent trucker strike, for example, can be a substantial detriment to a company’s ability to consummate sales, especially if the strike is in the company’s seasonal selling period. The new age e-commerce companies are particularly susceptible because they rely exclusively on a third-party distribution system. Companies selling perishable items are susceptible to weather, construction, and normal traffic pattern delays.

**Product and Service Risks**

The ability to differentiate one company’s product line from another is based on the profile of the particular product or service. For example, is the product or service a luxury or staple item? A luxury item to one market segment may be a staple item to consumers in a higher economic bracket.
Questions to ask include:

- Is the product line diversified?

- Is the product line diversified horizontally (i.e. many products being sold into the same market segment) or is the company selling the same types of products vertically into several different economic brackets?

  Product diversification is usually an advantage, a success factor, to the extent that it helps a company adapt to changing aggregate demand and meet more of each customer’s needs. However, a diversified product line is more expensive to support than producing and carrying inventory for a narrow product line.

- Is the product or service being purchased with discretionary income or with nondiscretionary income?

  In an economic downturn, purchases with discretionary dollars have a tendency to be curtailed, whereas nondiscretionary expenditures for staple goods and services tend to be the last ones eliminated from the consumer’s budget.

- Is the product or service vulnerable to style or technological obsolescence?

  This is an especially important question to ask of high tech marketers, such as those in the telecommunications and computer industries. Companies involved with the toy industry are also susceptible to obsolescence risks. If the product life cycle is relatively short, committing high fixed costs or financing the production or marketing infrastructure long-term may lead to cash flow problems for your customer.

- What is the demand for each product line?

  Demand influences sales volume, growth, and profit margins. Strong or growing demand is a success factor. However, if the product or service is faddish, the success could be short-lived.

- Is the product difficult or expensive to produce?

  Difficulty and expense involved in making the product can be positive or negative. It may mean the company can enjoy higher profit margins and less threat from new competitors. It also can mean that more capital is needed to operate the business and that customers demand higher quality standards.

- How do competitors differentiate their products or services?

  Uniqueness of the product usually is an advantage. However, a niche product line might limit demand for the product to a very small market segment. A niche product line is by definition a concentration, which is a risk factor. Alternately, if a product is a commodity, there is little opportunity to distinguish from competitors’ products and price becomes the sole basis of competition. Keep in mind that it is not just traditional commodities, such as sugar or ‘pork bellies’ that sell solely on the merits of price. Products become commoditized, or generalized, when the market’s offerings evolve into look-alike products. To some extent this process is a natural element of the product lifecycle. Successful companies find ways to add or enhance product features to extend the innovative life of their product or service, providing a continuing basis for value-added pricing.
• What value does the company add to the product?

Value added, like diversification can result in a competitive advantage, but it can be expensive to create and maintain. For example, bee keepers’ primary products are honey, wax, pollen, royal jelly, venom, bees and their larvae—all products produced naturally by the bees, with no value added by the bee keeper. The bee keeper that also produces a line of soaps or lotions that contain honey or royal jelly is selling value-added products, the pricing of which is independent of the more commodity-like honey and bee products. Of course, creating the manufacturing capability for soaps and lotions requires a significant investment of both capital and expertise, along with access to distribution outlets.

• Does the company incur product liability?

Food, pharmaceutical and cosmetic products bring obvious product liability risks, as do vehicles, many toys and infant products. Product liability is an inevitable business risk for many companies, and the management interview should include a discussion of the company’s product liability risk management programs.

**Production Risks**

What is the exact nature of the production cycle and facilities? Issues to be evaluated here are as follows:

• Do you consider your firm a processor, fabricator or assembler? You want to understand the length and complexity of the production cycle.

• How long or complex is the production cycle?

• Is the company susceptible to shutdowns in the production cycle caused by:
  - Labor unrest?
  - Raw material supply interruptions?
  - Equipment malfunctions or plant disasters such as a fire or flood?

• Does management have a plan in place in the event of a major disaster or other lengthy disruption in production or administrative function? Backup plans should be in place for critical functions. Has your customer continued to invest in fixed assets and their maintenance?

• Is there proper insurance on the production equipment, and does the company maintain business interruption insurance to ensure cash flow to pay overhead and debt service expenses in the event of lengthy production disruptions?

• Has your customer outsourced some or all of the production process?

• What is the present production capacity, what is the percentage of capacity utilization, and what are the economically efficient capacity increase increments?
• Where are the facilities located? If a company’s properties are well maintained, well located, and have value to other businesses (multi-purpose), these are advantages.

• Are facilities adequate, inadequate, or excessive? If the company has too many dollars invested in fixed assets and has a great deal of excess capacity or has spent more frivolously on nonproductive assets, these are risk factors. However, a company that has inadequate facilities, either in terms of location, size or efficiency, will also suffer.

• Does the company own or lease its premises? Owning or leasing is not a significant success or risk factor by itself. How does the company acquire the utilization of production and administrative fixed assets? How does the method of acquiring the asset (buy versus lease) affect the company’s financial activities?

• Does the production process introduce any environmental risk? Environmental contamination can arise from:
  - Pesticides
  - Poisons
  - Solvents
  - Petroleum products
  - Industrial chemicals
  - Animal by-products and waste
  - Metal fragments
  - Building materials

Companies are held legally responsible for appropriate handling of hazardous substances and other wastes. Severe financial and criminal penalties can be imposed on individuals or businesses found guilty of contaminating the air, land, or water. The costs associated with the cleanup and remediation of a contaminated site can cripple a business financially.

There are several levels of environmental audit that can be performed, and these are detailed in Dimension 6. The most comprehensive environmental audits must be performed by qualified professionals. However, you should do an initial screening by asking the company to disclose any production inputs or processes that create environmental risk, as well as their knowledge of any prior use of their property that might have created environmental hazard. Please see the Dimension 6 exhibit titled Signals of Environmental Problems: Things to Identify and Consider (SEPTIC) for additional help in understanding environmental risk.

**Technology Risks**

• Technology has allowed companies to increase staff efficiency and reduce personnel costs per unit sold or service provided as companies have grown.

• The economic efficiencies touted by proponents of technology do not come without risk.
The risks associated with technological advancement can be substantial and are as follows:

- Are there substantial costs to be incurred in the initial purchase of hardware and software?
- Will there be disruption to the company’s workflow during inevitable system upgrades or conversions?
- Are there concerns about whether a system is really as “user friendly” as purported by the seller of the system?
- Does your customer have a labor force that possesses the necessary skills to run the system, or will time and financial resources have to be spent in order to bring the workforce “up to speed”?
- How will the end-user be affected by any kind of system modification? It is not always invisible to the customer. How compatible is a system modification with any existing programs or systems that your customer may be utilizing in its operation?
- What kinds of system support risks are in existence after the system has been installed, and how financially stable is the support entity?

**Intellectual Property Risks**

Intellectual property (IP) risks can be direct and indirect. Direct IP risk is the risk of loss of control or value of the company’s unique knowledge assets that are embedded in its product or service. Indirect IP risk refers to the risk of loss of access to critical intellectual property, such as software, or the risk of litigation alleging improper use of others’ intellectual property.

Questions to ask that will help disclose IP risk include:

**Direct Intellectual Property Risk**

- What intellectual property does the company own, and how does it currently protect this IP? For example, what brands, logos, software programs, inventions or publications has the company developed, and how has it protected these with service marks, trademarks, patents, or copyrights?
- Does the company directly own the IP protections? For example, copyrights generally belong to authors unless specifically assigned to their employers or to clients when works are written by employees or contract workers. You should verify that the company owns or has received assignment to all legal rights to its intellectual property.
- Does the company require confidentiality agreements to be signed by all key employees, clients and contractors, to minimize the risk of proprietary secrets being compromised?
- What human resource retention programs are in place to minimize the loss of intellectual capital to competitors?
- How is the company protecting the value of its intellectual property, through continued research and investment in new product development or by purchase from outside developers? How adequate are financial and non-financial resources to ensure a seamless replacement or update of aging intellectual property? Non-financial resources include access to technology and to skilled employees or contractors.
• How effectively is the company monitoring the state of the art of its IP in the market? The company cannot protect the value of its IP through enhancements, or defend against any perceived infringement, if it is not aware of competitors’ evolving product or service offerings.

Indirect Intellectual Property Risk

• Is the company a legitimate owner or licensee of others’ intellectual property used for any business purpose? For example, ‘bootleg’ software, installed with or without the knowledge of company management, exposes the company to costly litigation risk.

• Does the company purchase critical software from vendors that provide an IP indemnification with the product license? A company may legally license software that subsequently becomes the target of litigation alleging it contains a competitor’s proprietary code. Although not responsible for the purloined code, the user may find itself embroiled in an IP dispute that can include a legal block against using the software in dispute.

• Does the company educate its employees about intellectual property responsibilities, and does it maintain and enforce policies to prevent unauthorized use of outside IP, such as copied software or copyright infringement?

Outsourcing Risks

A company may alter and increase its risk profile by outsourcing various functions; i.e. have other companies perform functions previously done in-house. The following risks should be considered whether your customer is a large user of outsourcing as a strategic initiative or outsources only a few, but very critical, functions:

<table>
<thead>
<tr>
<th>OUTSOURCING RISKS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credentials</strong></td>
</tr>
<tr>
<td><strong>Knowledge</strong></td>
</tr>
<tr>
<td><strong>Intellectual</strong></td>
</tr>
<tr>
<td><strong>Reputation</strong></td>
</tr>
<tr>
<td><strong>Financial Stability</strong></td>
</tr>
</tbody>
</table>
**OUTSOURCING RISKS**

<table>
<thead>
<tr>
<th>Licensing</th>
<th>Does the firm possess all of the necessary licenses needed to deliver the services, and does the firm have the ability to have those licenses renewed during the term of the outsourced contract?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capacity</td>
<td>Does the firm have the people/administrative capacity to deliver the services to be rendered or do they have to acquire additional capacity to handle this contract?</td>
</tr>
<tr>
<td>Technological</td>
<td>Does the firm have the technological capabilities and capacities to deliver the service and are their systems compatible with the client’s systems? Who provides their backup?</td>
</tr>
<tr>
<td>Contract Term</td>
<td>Review terms and conditions including reporting requirements. Ask your customer for a copy of the RFP (Request for Proposal) that the outsource firm completed when bidding on the contract.</td>
</tr>
</tbody>
</table>

**Other Risks**

You should look for risks that are not conveniently categorized in any of the sections previously described. Some risks to look for and questions to ask your customer are:

- What are the company’s critical success factors? What are the corporate attributes that make the business operate well?
- What are the greatest risks and opportunities in the industry and related industries?
- Are there any personnel issues or personal issues that could have major financial implications for the business going forward? For example:
  - The five “D’s” of credit: death, divorce, drugs, disagreements, or disabilities. Small businesses with limited management teams are particularly vulnerable to these risks.
  - Employee morale or pending legal actions.
  - Changes to compensation and benefit packages.

**Characteristics of Key Industry Sectors**

This section profiles the characteristics, special problems, and credit needs of the following industry sectors:

- Manufacturing Companies
- Wholesaling Companies
- Retailing Companies
- Service Companies
- Construction Companies
• Agribusinesses
• Educational Institutions
• Leisure/Tourism Industry
• Nonprofit Companies
• Government/Municipal Entities

**CHARACTERISTICS OF MANUFACTURING COMPANIES**

In manufacturing businesses, the timing of the production cycle (making and selling the product) is difficult to predict. As the production cycle increases, regardless of the industry, the receipt of cash takes longer, which results in the company having to maintain more cash on its balance sheet to meet liabilities as they come due. Depending on how vertically integrated they are, manufacturers usually have a considerable investment in both inventory and physical plant, so their percent of assets in cash relative to total assets may not be as high as it is for retailers.

There are three general types of manufacturers:

• Processors
• Fabricators
• Assemblers

The key to differentiating among these three types of manufacturers is to compare the level of vertical integration. Vertical integration relates to the portion of the manufacturing, marketing and service functions that are provided by the company internally rather than having another company provide any portion of those functions. Typically, the more your customer is vertically integrated, the longer its production and resulting cash cycle will be.

With the recent utilization and acceptance of outsourcing, the once fully integrated company no longer needs to be, nor is it necessarily economically appropriate for it to be fully integrated. Years ago, a company had to literally make their own parts before they could begin to fabricate or assemble the final product. In today’s world economy, with “just in time delivery,” there are fewer fully integrated processors and more assemblers.
Assets

A key to understanding the risks associated with a manufacturer is to analyze inventory management strategies. Levels of inventory will vary due to:

- Length of the manufacturing cycle, which directly relates to the amount of cash that is tied up in work-in-process.

- Difficulty of obtaining quality raw materials and parts, which directly dictates how much raw material must be kept on hand at all times. What is the permanent level of, and funding requirement for, raw materials in the company’s working capital assets structure?

- Reliability of the raw material delivery channel and duration of the shipment schedule.

- Stability of the labor force relative to issues such as the availability of required skilled labor and any labor agreements.

- Whether the company is producing goods for its finished goods inventory or whether it is producing goods to fill customer orders. This production strategy will dictate a company’s investment in the finished goods component of inventory.

- Planned production shutdowns for occurrences like holidays, model switchovers, or for seasonal reasons.

Processors and fabricators usually have a slower inventory turnover (i.e., more days’ sales in inventory) than manufacturers who only assemble what they sell. Generally, any type of manufacturer must invest heavily in production plant and equipment, so a manufacturer’s total working capital asset turnover is lower than in other industry sectors. Businesses that normally have low asset turnover are called capital intensive; they need many dollars invested in assets to generate sales.

Profitability

Profit is heavily influenced by:

- Proportion of variable costs to fixed costs.

- Competition.

- Amount of “perceived” value added.

As with any industry, the more competition there is, the lower the profit margin will be. In addition, the more value (perceived or real) a company adds to its product or service, the higher the profit margins are likely to be. Therefore, because manufacturers are “perceived” to add more value, their profit margins are usually larger than those exhibited by wholesalers or retailers.

Other Considerations

Manufacturers bear the brunt of product liability and performance representations of the products that they produce. Typically they provide product guarantees that the consumer relies on in the purchase decision. These guarantees contribute significantly to the “value added” equation.
Asset Distribution Characteristics

As an example, a manufacturer of Candy and Other Confectionery Products (SIC # 2064/NAICS # 31133) would have the following asset distribution characteristics:

For the asset distribution characteristics of other manufacturers, you should refer to the most recent edition of RMA’s *Annual Statement Studies—Financial Ratios Benchmark*.

The following is a summary of the general characteristics, special problems, and credit needs of manufacturers.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>• Dominated by larger, more mature firms  • High fixed assets requirements  • High fixed costs  • High cyclicality  • Moderate seasonality</td>
<td>• Cost accounting  • Fixed cost management  • Inventory control  • Long-term forecasting  • Equipment/process obsolescence  • Environmental considerations</td>
<td>• High credit needs; borrowing tends to be short and long term  • Particular needs include:  ➢ Financing of fixed assets  ➢ Financing of working capital assets</td>
</tr>
<tr>
<td>Processor</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fabricator</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assembler</td>
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</tr>
</tbody>
</table>
CHARACTERISTICS OF WHOLESALING COMPANIES

Wholesalers are distributors or middlemen who buy a finished product or component parts directly from the manufacturer and sell these goods to users other than the ultimate consumer. Their “value added” results from the availability, storage and movement of the product. In contrast to “brokers,” wholesalers take title to the goods and control over their physical movement. Due to the intense competition among wholesalers and the relative ease with which new companies can enter the industry, the cash cycle tends to become stretched out. Wholesalers, especially those selling commodity products, differentiate themselves by offering liberal credit terms in order to boost sales and attract or retain customers.

Assets

- Cash reserves must be slightly higher than in less competitive sectors.
- Accounts receivable may represent a considerable percentage of total assets and their collection may be slow.
- Inventory will also represent a considerable percentage of total assets as they try to carry enough inventory to meet anticipated demand. Well-managed wholesalers tend to turn their inventory faster than retailers because retailers are forced to stock for seasonal demand and deal with unpredictable consumer buying patterns.

Profitability

Profitability is dependent on how an individual wholesaler differentiates itself from the competition and the level of “value added.” Because wholesalers generally add less value in the sales cycle, they have a tendency to show lower profit margins than manufacturers or retailers.

Other Considerations

Brokers act as an “outsourced” sales force for the manufacturers that they represent.

- Broker’s value added is in the “intellectual” value added by the sales force that may have particular expertise in an industry or group of related industries. The purchaser looks to the broker’s sales force as a source of information and not just a source of product.
- Brokers typically have a large percentage of their assets in accounts receivable and collection may be slow.
- The need for cash is dependent on the disparity between accounts receivable turnover and accounts payable turnover.
- There should be no investment in inventory as the goods are shipped directly from the manufacturer.
- There is little investment in fixed assets because a broker neither manufactures nor stores any product.
- Typically wholesalers do not have a significant risk in product liability or performance guarantees.

Large retailers (“mega” retailers) in certain industries have cut out the wholesaler from the sales cycle by incorporating the wholesaler’s function into their own operation.
• Mega retailers buy directly from the manufacturer (sometimes under the retailer’s label) and sell directly to the consumer.

• Mega retailers may use a captive centralized warehouse and distribution system in order to economically enhance product distribution logistics. The sheer buying power of these large retailers allows for this business strategy to work. The profit center eliminated and economies gained by reducing distribution costs, as a result of cutting out the traditional wholesaler, presumably increases the mega retailer’s gross margin while also discounting the price of the product to the ultimate consumer.

In many industries, wholesaling is a vibrant sector, which uses inventory control technology and creative transportation to ensure its place in the sales cycle.

**Asset Distribution Characteristics**

As an example, a wholesaler of Computers, Peripheral Equipment & Software (SIC # 5045/NAICS # 42343) would have the following asset distribution characteristics:

For the asset distribution characteristics of other wholesalers, you should refer to the most recent edition of RMA’s *Annual Statement Studies—Financial Ratios Benchmark*. 
The following are general characteristics, special problems, and credit needs of wholesalers.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wholesaling</strong></td>
<td>• Dominated by small firms</td>
<td>• Gross margin management</td>
<td>• High credit needs including:</td>
</tr>
<tr>
<td></td>
<td>• Size and location of warehouse facilities and equipment varies</td>
<td>• Inventory control technology</td>
<td>➢ Equipment financing</td>
</tr>
<tr>
<td></td>
<td>• Low fixed costs</td>
<td>• Accounts receivable collection</td>
<td>➢ Short term loans to finance the cash conversion cycle</td>
</tr>
<tr>
<td></td>
<td>• Accounts receivable and inventory are usually the biggest assets</td>
<td>• Structuring debt requirements properly</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Moderate cyclicality</td>
<td>• Needs a quick cash-to-cash cycle</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Low seasonality (depending on subsector)</td>
<td>• Available transportation networks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Lowest level of profitability due to least “value added”</td>
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</table>

**CHARACTERISTICS OF RETAILING COMPANIES**

Retailers buy goods from wholesalers or, in the case of large retailers, directly from the manufacturers. Retailers’ “value added” results from providing convenience, product selection, and consultation to the ultimate consumer. There is intense competition in retailing and there exists relative ease of entry for new companies (especially smaller ones) into the market.

**Assets**

- Small or local retailers will carry their own accounts receivable. Larger retailers do not carry their own accounts receivable as that function and risk have been outsourced to the national credit card companies.

- The risk of lending to retailers is in their physical location, quality and marketability of their inventories and quality of their service.

- For regional and national retailers, there is considerable investment in retail outlets and personnel costs.
**Profitability**

The retailer’s “value added” can be considerable and results in higher gross margins than those exhibited by the wholesaler and, in some cases, even the manufacturer. Value added comes in the form of:

- Convenience for the consumer.
- Product selection – style and features.
- Sales terms – discounts, returns and allowances, payment terms.
- Technical advice.
- Backup to manufacturers’ representations and warranties.
- Price.

**Other Considerations**

Some retailers sell products under exclusive distributorship arrangements with specific manufacturers that contain valuable protected territory provisions. This contractual relationship results in the manufacturers being able to have significant influence over the marketing and pricing strategies of their products. The benefit is that the retailer has a branded product to sell with recognized product performance and reliability. The inventory risk is mitigated because of its known marketability and because the manufacturer may provide your financial institution with a buyback agreement for all unsold inventory. The buyback agreement could substantially reduce your risk in lending to a retailer, but benefits of such an agreement need to be well documented in your loan agreements.

Franchise agreements under which some retailers operate also reduce the operating and marketing risks, because of the marketing credibility provided by an established franchisor. Generally, the risk to you as a lender is not in the marketability or quality of the product, but in the location of the retailer relative to the existing or potential marketplace. It is important to understand the underlying terms and conditions of the franchise agreement, as well as the overall strength and reputation of the franchisor.

Depending upon the products sold, a retailer may have to deal with unpredictable consumer demand. Retailers have the challenge of stocking the right amount of inventory for which there is steady demand, but in unpredictable amounts. In other cases, to meet unknown or volatile consumer demand, the retailer may have to stock inventory in, or have quick access to, a wider and deeper array of products than other competitors in the marketing channel, including the new E-commerce retailer.

There are many nuances to retailing today, and to establish a valued lending relationship with the customer, you need to understand exactly how your customer purchases and sells its products.
Asset Distribution Characteristics

As an example, a small retailer of Cameras & Photographic Supplies (SIC # 5946/NAICS # 44313) would have the following asset distribution characteristics:

For the asset distribution characteristics of other retailers, you should refer to the most recent edition of RMA’s Annual Statement Studies—Financial Ratios Benchmark.

The following are general characteristics, special problems, and credit needs of retailers.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
</table>
| Retailing | • Dominated by small firms – some “mega” retailers coming into market  
• Low fixed asset requirements – unless “mega” retailer  
• High inventory requirements  
• Moderate to high cyclicality  
• Variable seasonality  
• Tends to have high margins due to value added | • Gross margin management  
• Inventory management  
• Fixed cost management  
• Sales force hiring, training and retention | • Credit needs may include:  
➢ Short-term loans to finance the cash conversion  
➢ Occasional seasonal line of credit  
➢ Term loans or leases for fixed asset acquisitions. |
CHARACTERISTICS OF SERVICE COMPANIES

Service businesses generate their revenues more from the marketing of expertise and knowledge possessed by their employees than from the sale of goods.

Assets

- Accounts receivable tend to be a service company’s major asset and their turnover tends to be slower than in some other industry sectors. As a lender to a service company, your risk is the ultimate collectability of the accounts receivable. The longer the accounts receivable payment cycle, the more susceptible the company is to nonpayment. In addition, the “quality” of the service provided can often result in disputed receivables making it important to understand the past track record of the service provider.

- The issue of accounts receivable financing on a “whole account basis” is especially critical in lending to service companies. The “whole account basis” is discussed further in Dimension 3 but basically refers to the process of eliminating the entire amount of an account receivable for financing purposes if any amount is due beyond a defined acceptable age.

- Service companies have very little inventory.

- Generally, they are not capital intensive, although large professional service companies (lawyers, CPAs, engineers, money managers) can have a considerable investment in buildings and office equipment.

Profitability

Profit margins are generally high, especially when the service provided is either unique or complex, and requires specialized talents or skills. Value of the service is “in the mind of the customer.” Margins are somewhat lower, when the service is a commodity service, i.e. it is simple, doesn’t take long to provide, and doesn’t require highly technical skills.

Other Considerations

Historically, there have been relatively low barriers to entry in the service sector. This is especially true of commodity-type services. However, in service businesses dependent upon unique or reputable skills, such as money management firms and internet-based service companies, significant funding for relatively high fixed personnel costs will be required. Any service business that is dependent upon licenses in order to operate may also have significant costs of entry.

The cost of entry to a particular service sub-sector will have significant influence on the risk that you take in lending to a service firm.
**Asset Distribution Characteristics**

As an example, a firm providing Accounting, Auditing & Bookkeeping Services (SIC # 8721/NAICS # 54121) would have the following asset distribution characteristics:

For the asset distribution characteristics of other service firms, you should refer to the most recent edition of RMA’s *Annual Statement Studies—Financial Ratios Benchmark*.

The following are general characteristics, special problems, and credit needs of service companies.
### SERVICE BUSINESSES: FEATURES

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Services</td>
<td>• Dominated by small firms</td>
<td>• Labor expense management</td>
<td>• Credit needs may include:</td>
</tr>
<tr>
<td></td>
<td>• High investment in accounts receivable</td>
<td>• Job costing</td>
<td>➢ Equipment financing</td>
</tr>
<tr>
<td></td>
<td>• Fixed asset requirements depend on size of company</td>
<td>• Pricing</td>
<td>➢ Short term loans to finance the cash conversion cycle.</td>
</tr>
<tr>
<td></td>
<td>• Low fixed costs, except personnel costs</td>
<td>• “Value” perception of service provided</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Low cyclicality</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Moderate seasonality</td>
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</tr>
<tr>
<td></td>
<td>• Margins tend to be higher in specialized knowledge businesses</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Low barriers to entry in “commodity” services</td>
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</tbody>
</table>

### CHARACTERISTICS OF CONSTRUCTION COMPANIES

The construction industry experiences unpredictable timing of cash receipts, keen competition, and costs that are difficult to predict and control. There are some general guidelines that are applicable to most companies in the construction industry.

**Assets**

- There is a general need for relatively high levels of cash. The cash cycle can be unpredictable, depending on how payments are made under specific contracts. Large outflows of cash for labor and equipment utilization are routine. Bonding companies that provide completion and performance bonds to the ultimate purchaser often require a minimum level of cash to be available at all times, which can reduce the amount of cash available for ongoing requirements.

- Because of staged or progress payments, large sums of money are often tied up in receivables that will not be collected until approval or acceptance by the purchaser, or until a project is completed. If progress payments are made to help reduce a construction company’s investment in accounts receivable, there are retainages or retentions (often called holdbacks) that must be financed until the completion of the job. For large contracts, retainages of typically 10% can represent significant dollars.

Costs in excess of billings (asset) and billings in excess of costs (liability) are balance sheet categories that can mitigate risk or create risk. If these accounts are significant in
their absolute amount, or if there exists a large difference in the relative balances between the two accounts, this can represent a significant source of funds (liability) or use of funds (asset). In a contractor’s financial statements:

- Costs in excess of billings (an asset) represents the difference between the total of costs and recognized estimated earnings to date and the total billings to date.
- Billings in excess of costs (a liability) represents the difference between the total billings to date and the total of costs and recognized estimated earnings to date.

- Inventory requirements are typically low, as material is purchased and priced for specific contracts.
- Historically, fixed assets (mostly equipment) have made up a large part of the construction company’s balance sheet. This may still be true for companies with equipment that can be used repeatedly for many different contracts and which does not exhibit great technological obsolescence. There is a trend away from outright ownership of equipment to a strategy of gaining the utility of the required piece of equipment for only the time period for which it is needed. This equipment utilization is gained through a leasing or rental agreement. This leasing/renting strategy increases variable expenses that are expensed through contracts, but should reduce a construction company’s fixed expenses.

**Profitability**

Profitability is typically predicated upon:

- Total volume of work
- Accuracy in job costing
- The control of fixed expenses allocated to individual jobs.

**Asset Distribution Characteristics**

As an example, a construction company focusing on Bridge, Tunnel & Elevated Highway Construction (SIC # 1622/NAICS # 23731) would have the following asset distribution characteristics:
For the asset distribution characteristics of other types of construction enterprises, you should refer to the most recent edition of RMA’s *Annual Statement Studies—Financial Ratios Benchmark*.

For articles about construction lending, see the Construction, and Construction Contractors *Industry Studies Packs* by RMA.

The following are general characteristics, special problems, and credit needs of construction businesses.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>• Dominated by small firms</td>
<td>• Job costing</td>
<td>• Credit needs may include:</td>
</tr>
<tr>
<td></td>
<td>• Low to moderate fixed asset requirements</td>
<td>• Fixed cost management</td>
<td>➢ Revolving lines of credit for accounts receivable financing</td>
</tr>
<tr>
<td></td>
<td>• High accounts receivable and retainages</td>
<td>• Management of direct versus indirect costs</td>
<td>➢ Equipment financing</td>
</tr>
<tr>
<td></td>
<td>• High cyclicity</td>
<td>• Cash flow projections</td>
<td>➢ Project financing</td>
</tr>
<tr>
<td></td>
<td>• Moderate to high seasonality</td>
<td>• Balancing accounts for costs in excess of billings</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>and billings in excess of costs</td>
<td></td>
</tr>
</tbody>
</table>
CHARACTERISTICS OF AGribusinesses

Agriculturally oriented businesses, i.e. agribusinesses, have two significant categories on their balance sheet: inventory and fixed assets. These businesses face a number of risks in getting their product to market:

- Changes in consumer eating habits
- Changes in the environment
- Disruptions in the growth of the product due to sudden changes in weather or prolonged weather patterns
- Disease
- Changes in government regulations
- Changes in the market price for the end product

Assets

- Inventory represents direct costs associated with the growth of a plant or animal until sold in the market.

- Agribusinesses typically have a very large investment in land. While the preponderance of family farms is decreasing, there are still significant land holdings dedicated to farming. The cost basis of the land as recorded on the company’s financial statements is an important number. If the land has been handed down from generation to generation, there is a low cost basis. If land must be purchased at today’s market price, this can represent a large portion of the company’s assets and be a significant call on cash. This asset requires relatively little maintenance other than fertilizers and insecticides to keep it fertile for the proper crop or grazing rotation.

- The equipment necessary to “work” the agribusiness represents another significant portion of the company’s assets. It is generally expensive to purchase and maintain, and often cannot be leased or shared in a cooperative because of concurrent harvesting or slaughtering schedules.

Profitability

Profitability relates to the price of the product received at the time of sale less the costs incurred over the period of time to bring the product to market. There can be considerable volatility in both costs and market prices from one growing season to the next. There are several unique aspects in accounting for agriculture and these need to be understood to gain an appreciation of the actual profitability. For example, much of the accounting for agriculture is cash accounting versus accrual, which can provide significantly different results.

Other Considerations

Agribusinesses are asset-intensive and susceptible to large swings in buying patterns and market prices. This industry’s ability to control disease and avoid the impact of sudden changes in weather patterns is key to its profitability and survival.
Asset Distribution Characteristics

As an example, an agribusiness growing vegetables (Agricultures – Farm- Vegetable, SIC # 0161/NAICS # 11121) would have the following asset distribution characteristics:

For the asset distribution characteristics of other agribusinesses, you should refer to the most recent edition of RMA’s Annual Statement Studies—Financial Ratios Benchmark.

The following are general characteristics, special problems, and credit needs of agribusinesses.
## AGRIBUSINESSES: FEATURES

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agribusiness</td>
<td>• Historically dominated by small farms — large or “mega” farms coming into existence</td>
<td>• Access to land</td>
<td>• Credit needs may include:</td>
</tr>
<tr>
<td></td>
<td>• High fixed asset requirements – depends on how the use of land is acquired</td>
<td>• Disease control</td>
<td>➢ Short-term loans to finance the cash conversion cycle with a seasonal line of credit</td>
</tr>
<tr>
<td></td>
<td>• High inventory costs</td>
<td>• Changes in weather patterns</td>
<td>➢ Term loans leases for fixed asset acquisitions</td>
</tr>
<tr>
<td></td>
<td>• Moderate cyclicality</td>
<td>• Cost to grow product</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• High seasonality</td>
<td>• Fixed cost management</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Sales volatility and use of futures contracts to stabilize selling price</td>
<td></td>
</tr>
</tbody>
</table>

## CHARACTERISTICS OF EDUCATIONAL INSTITUTIONS

Like other nonprofit enterprises, the cash flow cycle is characterized by the significant inflow of cash, such as grants and fund raising from sources other than from the customers (students) of the institution. For some educational enterprises, this cash flow, regardless of its source, can be relatively predictable; for others it is not.

### Assets

- **Cash balances** are susceptible to significant swings based upon timing in the business cycle (i.e. semesters), and the health of the institution’s endowment and investment funds. The level of cash is dictated by the timing and amount of tuition inflows and the movement of funds from endowment funds into the operating accounts.

- **Accounts receivable** are seasonal. The amount can be relatively insignificant when tuitions have been billed but not collected.

- **The industry** is characterized by large investments in fixed assets. Fixed assets, comprised of land, buildings, and equipment, are very expensive to purchase and maintain. The purchase funding typically comes from the fundraising activities of entities and individuals friendly to the institution. The funds for maintenance come from the operating fund of the institution. The amount of land and buildings as recorded on the institution’s balance sheet depends on when the investment was made, and may not reveal very much to a lender about its current value or alternative use. Equipment is usually highly specialized, especially in research facilities, expensive to buy, and is subject to quick obsolescence. Again, depending on its purchase date and useful life, the large amount of equipment usually found at an educational institution may not be
reflected on the balance sheet. Only when a piece of equipment or building needs to be added or replaced does the significance of the demands on cash become known.

- Endowment funds in well-established institutions comprise a large portion of their total assets. The magnitude of these funds can vary substantially according to the fortunes of the investment strategy and general market conditions. Many of these funds are dedicated to support specific activities or programs at the institution and are generally not available to pay operating expenses of the institution including debt service.

**Profitability**

The excess of revenues over costs is highly influenced by the percentage of fixed costs to variable costs. Therefore, fixed cost management or financial leverage is a critical management strategy for maximizing the excess of revenues over costs. The major outflow of funds is for fixed instructional salaries and maintenance costs for the vast campuses owned by an institution.

**Other Considerations**

How an educational institution is chartered as public or private dictates how it is funded. The institution’s ability to attract a qualified student body without giving significant scholarships impacts its cash flow from tuition. The age of the institution’s campus will influence maintenance costs.

**Asset Distribution Characteristics**

As an example, a college (Services – Colleges, Universities & Professional Schools, SIC # 8221/NAICS # 61131) would have the following asset distribution characteristics:
For the asset distribution characteristics of other educational enterprises, you should refer to the most recent edition of RMA’s *Annual Statement Studies—Financial Ratios Benchmark*.

For related articles, see the Colleges and Universities and Private Schools Industry Studies Packs by RMA.

The following are general characteristics, special problems, and credit needs of educational businesses.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Educational</td>
<td>• High fixed asset requirements</td>
<td>• Ability to attract a qualified student body and instructors</td>
<td>• Revolving lines of credit to fund operating expenses pending tuition receipts</td>
</tr>
<tr>
<td></td>
<td>• High accounts receivable – tuition receipts</td>
<td>• Management of tuition and endowment funds</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Moderate cyclicality</td>
<td>• Cash flow projections</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Low seasonality</td>
<td>• Fixed cost– instructional salaries and campus maintenance management</td>
<td></td>
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</tbody>
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**CHARACTERISTICS OF THE LEISURE/TOURISM INDUSTRY**

Inherent in the leisure industry are an unpredictable cash flow and intense competition from similar companies as well as from companies offering other forms of leisure activity. For the most part, this industry depends on its customers’ discretionary spending and therefore is tied to the health of the economy and to people’s attitudes towards spending on recreation.

**Assets**

- The leisure industry tends to have large cash balances in order to fund expenses during seasonal periods of erratic cash inflows.
- Accounts receivable are typically not a large portion of a company’s asset structure, as that function is provided by the national credit card companies.
- Fixed assets are usually a significant portion of the company’s asset structure, and these may be comprised of land, buildings, and equipment. There is a trend to ward “mega” companies in this industry because of the large amount of funding required from both the debt and equity markets.

**PROFITABILITY**

Profit margins are heavily influenced by consumer spending of discretionary dollars and by capacity utilization. Since the industry is fixed-expense driven, after breakeven cash inflows are achieved, incremental cash inflows contribute significantly to net income. Depreciation
expense (noncash) is a significant portion of total expenses, because of the inordinately large investment in fixed assets. Costs of adhering to environmental concerns can be substantial and unpredictable.

OTHER CONSIDERATIONS

The borrowing needs result from the need to pay day-to-day operating expenses and large amounts of long-term debt, or bridge financing, required to fund fixed asset construction or acquisition. The lead-time in acquiring assets is generally greater than one year and can extend over an entire business cycle, during which consumer-spending habits can change dramatically.

ASSET DISTRIBUTION CHARACTERISTICS

As an example, a company operating hotels (Services – Motels, Hotels & Tourist Courts, SIC # 7011/NAICS # 72111) would have the following asset distribution characteristics:

![Asset Distribution Chart]

For the asset distribution characteristics of other leisure-oriented companies, you should refer to the most recent edition RMA’s Annual Statement Studies—Financial Ratios Benchmark.

For related articles, see Hotels, an RMA Industries Studies Pack.
The following are general characteristics, special problems, and credit needs of the leisure industry.

<table>
<thead>
<tr>
<th>LEISURE BUSINESSES: FEATURES</th>
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<tbody>
<tr>
<td><strong>INDUSTRY</strong></td>
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<tr>
<td>Leisure</td>
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CHARACTERISTICS OF NONPROFIT COMPANIES

The nonprofit industry has grown into a significant sector in terms of asset size and employment base. The industry is characterized by volatile cash flows dependent on patron giving patterns and the receipt of grants.

**Assets**

- A nonprofit organization generally maintains a large amount of cash relative to its total asset size and annual operating budget.

- The accounts receivable base and subscriptions receivable can be large in relation to total assets and have a tendency to turn slowly. The funding for payment of accounts receivable may be a government appropriation, which typically pays slowly. The subscriptions receivable are scheduled giving by donors but can be susceptible to sudden downturns in the economy. The borrowing needs of nonprofit organizations result from the need to pay day-to-day operating expenses pending collection of accounts receivable.

- The asset structure for large nonprofits may include significant investments in land, buildings and equipment; however, most nonprofits serving a small local constituency have very few fixed assets.

**Profitability**

- Cash flow sources are annual renewals of grants, government funding and private donations. The sustainability of annual operating cash flows depends on the health of the economy and the credibility of the organization in the market that it serves. The reliability of government funding under annual contracts is often questionable, unless the nonprofit
provides a mandated service for which funding is annually appropriated by a specific government agency.

- Larger nonprofits with a long history may have substantial endowments. While the earnings from these funds may be available to meet operating needs of the nonprofit, the principal amount of most endowment funds is restricted for a specific purpose or program.

- Smaller nonprofits typically do not have the benefit of substantial endowment assets.

Other Considerations

The health of the economy in general and the appeal of the “cause” will greatly influence the level of annual charitable giving to nonprofits. Minimizing fixed costs and being able to attract personnel on a variable cost basis (or volunteer) is instrumental to their financial health.

Asset Distribution Characteristics

As an example, a small local nonprofit, if it owns its own facility, might have the following asset distribution characteristics:

For related articles, see Nonprofit Organizations an RMA Industries Studies Pack.
The following are general characteristics, special problems, and credit needs of nonprofits.

### NONPROFIT BUSINESSES: FEATURES

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>CHARACTERISTICS</th>
<th>SPECIAL PROBLEMS</th>
<th>CREDIT NEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nonprofit</strong></td>
<td>• Dominated by small firms</td>
<td>• Fixed cost management</td>
<td>• Credit needs including:</td>
</tr>
<tr>
<td></td>
<td>• Low fixed costs</td>
<td>• Accounts receivable and subscriptions receivable collection</td>
<td>➢ Short term loans to finance the cash conversion cycle</td>
</tr>
<tr>
<td></td>
<td>• Cash and Accounts receivable are usually the biggest assets – unless they own their own building</td>
<td>• Structuring debt requirements properly</td>
<td>➢ Equipment financing term</td>
</tr>
<tr>
<td></td>
<td>• Moderate cyclicality</td>
<td>• Level of philanthropic giving</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Low seasonality</td>
<td>• Level of volunteerism</td>
<td></td>
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</tbody>
</table>

### CHARACTERISTICS OF GOVERNMENT ENTITIES

The level and predictability of cash flow is key when lending to this large economic sector. Most cash inflows are a direct result of taxation. The inflow of tax dollars is related to the health of the economy (for both earned and unearned income) and the size of the population served. For the taxing entity, the timing of cash inflows is predictable because tax due dates are historically established and seldom change.

**Assets**

The value and marketability of assets are not issues in underwriting loans or bond issues to government or quasi-government enterprises. Repayment of credit to this sector depends solely on the ability of the entity to tax directly or to receive tax dollars by appropriation. Generally, liquidation of assets is not a viable second source of repayment.

**Profitability**

Annual tax receipts must cover annual operating and debt service expenses with any excess transferred into an investment account. For a government-run utility, such as a waste management facility, cash outflows are mostly for fixed expenses. With other types of government entities, cash outflows may be mandated under entitlement programs, whereas other cash outflows rise and fall with the economic health of the taxpayer.

**Other Considerations**

Most extensions of credit to this sector are relatively risk free as to payment, but there can be interest rate risk issues because these entities typically require long term fixed rate financing.
Asset Distribution Characteristics

As an example, a public waste management entity (Public Administration- Air & Water Resource and Waste Management, SIC # 9511/NAICS # 92411) would have the following asset distribution characteristics:

For the asset distribution characteristics of other public administration entities, you should refer to the most recent edition of RMA’s Annual Statement Studies—Financial Ratios Benchmark.

For related articles, see the Municipalities Industry Studies Pack by RMA.

The following are general characteristics, special problems, and credit needs of government entities:

<table>
<thead>
<tr>
<th>GOVERNMENT ENTERPRISES: FEATURES</th>
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</thead>
<tbody>
<tr>
<td>INDUSTRY</td>
</tr>
<tr>
<td>CHARACTERISTICS</td>
</tr>
<tr>
<td>SPECIAL PROBLEMS</td>
</tr>
<tr>
<td>CREDIT NEEDS</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government &amp; Quasi-Government Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>High fixed asset requirements</td>
</tr>
<tr>
<td>High accounts receivable prior to annual tax receipts</td>
</tr>
<tr>
<td>Low cyclicality</td>
</tr>
<tr>
<td>Low seasonality</td>
</tr>
<tr>
<td>Ability to tax at rate to cover operating expenses, and retire loans or bond issues</td>
</tr>
<tr>
<td>Fixed cost management</td>
</tr>
<tr>
<td>Management of investment funds</td>
</tr>
<tr>
<td>Cash flow projections</td>
</tr>
<tr>
<td>Revolving Lines of Credit to fund operating expenses pending tax receipts</td>
</tr>
<tr>
<td>Equipment and building financing via Term Loans and/or Mortgage Financing.</td>
</tr>
</tbody>
</table>
Evaluating the Client’s Market

Evaluating the client’s market includes analyzing the client’s customers and suppliers, including relationships, concentrations, ability to perform for the bank’s client (such as timely payment of receivables and delivery of product to specification) and long-term stability. To evaluate market risks, consider the following areas of analysis:

- **Buyer/Supplier Profiles**: how do the characteristics of buyers and suppliers in an industry influence the borrower’s market opportunities?

- **Buyer/Supplier Concentrations**: to what extent does an industry depend on a relatively small group of suppliers and /or customers?

- **Entry and Exit Costs**: What barriers exist to entering the industry, and what costs must be borne to exit?

- **Vulnerability to Substitutes**: What product or service substitutes are readily available?
The characteristics of an industry’s buyers and suppliers define many aspects of a borrower’s market opportunity. These characteristics include not only the size of the market and typical buyer purchasing motivation, but also industry selling terms and collection standards as well as the industry sales and distribution process. Key considerations to include in an industry buyer/supplier analysis (as well as when analyzing an individual customer’s buyers and suppliers) include:

<table>
<thead>
<tr>
<th>Issues</th>
<th>Interpretations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are the buyers individual consumers, retailers, wholesalers, distributors, or other manufacturers?</td>
<td>The characteristics of the market, such as the number, size, and type of potential buyers, affect marketing strategy. A comprehensive marketing strategy includes considerations of advertising, sales, delivery, and service after the sale. Generally, a marketing strategy that is simple and inexpensive is an advantage, but complex or expensive ones can also be an advantage if they result in strong customer loyalty and brand recognition.</td>
</tr>
<tr>
<td>Is the market made up of a few large buyers or many smaller ones?</td>
<td>Number and size of each customer impacts the company’s ability to set prices. Number, size, and creditworthiness of customers also affect collectibility of accounts receivable. Many small accounts may mean more collection and credit investigation expense but also a smaller loss potential on each account. Concentration of accounts with just a few major buyers means the company is vulnerable to losing a large portion of its sales if it loses just one customer. Fewer, larger accounts simplify credit and collection process.</td>
</tr>
<tr>
<td>What influences buyers to buy—quality, service, price or some other product/service characteristic?</td>
<td>When price is the main determinant of purchase, the company is more vulnerable to price competition. When quality or service is the determinant, the company has a better opportunity to create customer loyalty, a success factor. Determine how the company differentiates its products/services in the marketplace.</td>
</tr>
<tr>
<td>What are typical selling terms and collection policies?</td>
<td>Are their sales terms a point of influence to the purchase decision? Does the company enforce their collection policy?</td>
</tr>
<tr>
<td>What is the sales and distribution process?</td>
<td>Evaluate the sales and distribution process by considering the control the company has over its distribution system and the opportunity for higher profits relative to the costs of the system.</td>
</tr>
</tbody>
</table>
## Supplier Profile Analysis

<table>
<thead>
<tr>
<th>Issues</th>
<th>Interpretations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who are the main suppliers to the industry?</td>
<td>The characteristics of the market, such as number, size and type of potential suppliers affect the purchasing and pricing strategy.</td>
</tr>
<tr>
<td>What are the suppliers’ typical credit terms?</td>
<td>When a company has favorable trade terms from its suppliers, it is a success factor in terms of pricing and as a source of funds. However, such a company is always vulnerable to changes in those terms, which might cause it to need more cash.</td>
</tr>
<tr>
<td>Do major suppliers allow their customers to owe extensive levels of accounts payable?</td>
<td>If additional credit amounts or extended terms are available from trade suppliers, they provide a source of cash for the company. If suppliers require that credit levels be reduced or payment terms reduced, the company must raise cash from other sources.</td>
</tr>
<tr>
<td>Are there alternative sources of supply?</td>
<td>When a company depends on a single source, or very few sources of supply, it is vulnerable to product availability and to price controls. Generally, having multiple sources of supply is a success factor. However, if a company is a significant buyer from one supplier, it may be able to take advantage of special pricing or deferred payment terms, which may also be a success factor.</td>
</tr>
<tr>
<td>What other uses does the raw material have?</td>
<td>When a company’s raw material is also used in other industry, events in that industry can drastically affect the company’s costs and ability to obtain the material. Generally, it is positive for a company’s raw material inventory to have uses to other industries/businesses in case you or your borrower needs to dispose of the items under adverse circumstances.</td>
</tr>
</tbody>
</table>
Buyer/Supplier Concentrations

There is a huge upside potential and downside risk in any kind of concentration on either side of the balance sheet. Concentrations make a company vulnerable to the fortunes (financial or otherwise) of either a few customers or a few suppliers. On the other hand, by definition, companies selling into a niche market have a concentration that they have strategically selected. In that case, hopefully your customer’s management has evaluated the niche market and the risks associated therewith, and decided that the business strategy chosen is an acceptable business risk. Your acceptance of the risk in that niche market may be quite different. For definitional purposes, your customer is the Buyer or Supplier.

Buyer Concentration

Your customer can put himself in jeopardy by only having one or just a few potential sources of supply. If the purchased product or service can only be obtained through one company, or there are just a few suppliers, you as the financing entity are at substantial risk because any disruption in the flow of that product or service puts your customer into a non-production or non-service mode. This will quickly affect cash inflow and consequently your customer’s ability to repay its loan to your institution. Only buying from one, or a few suppliers or perhaps several is not necessarily a concentration, if the item or service is widely available from other sources in the market place.

Supplier Concentration

By selling to only a few customers, your customer will inherently create selling concentration. If this marketing strategy is by design with mostly variable production costs and minimal fixed costs, and the end-users are financially stable, then you can have a very acceptable level of risk. If your customer has significant fixed costs and they lose one customer and can’t replace that customer readily, then severe cash flow difficulties can arise. In your analysis of your customer, you should also analyze its customers if there are only a few. Beware of the company that says its business is well diversified, yet survives on the 80/20 rule (20% of the company’s customers supply 80% of the profits)—that is indeed supplier concentration!

Entry/Exit Costs

This theory, which makes it costly for a company to enter or leave an industry or line of business, was originally predicated on the view that cost of fixed assets is the primary deterrent to competing in a particular industry. While still a crucial factor as to whether to enter an industry or not, there are now several other factors of equal or greater importance. Additional deterrents to entering an industry can be the cost of:

- Technology
- Specialized labor
- Regulatory compliance and licenses
- Acquiring market credibility
Exit costs include:

- Government imposed restrictions on plant and office closings in which a minimum number of people are employed.

- Economic harm that is done to an entire company as a result of shutting down one product line. Negative public relations from a plant or administrative office closing can cause irreparable damage.

For a company that is considering entering or exiting a business, you should ensure that they have a well thought out strategic plan for such a move. You should evaluate the ramifications of that action as it pertains to the covenants in the company’s loan agreement with your institution and the company’s prospective cash flow. Exit costs borne by your financial institution in a workout situation could severely impact your second way out of a loan if it means liquidating production capacity or selling an administrative building, either of which would put people out of work.

**Vulnerability to Substitutes**

History has shown that entire industries have been replaced through innovation and changes in consumer buying habits. In analyzing this risk, you should determine how the risk of vulnerability to substitutes would affect your customer’s creditworthiness.

- What is the change in consumer buying habits that are either style, health, or economic driven?

- Is the product or service generic in nature, has it been around for a long time and is it considered a basic consumer commodity?

- Is the product or service a passing fad that is purchased by a very narrow band of the consumer marketplace?

The answer to these questions will determine management’s commitment to capital appropriation and your interest in financing the product or service. Be very careful not to superimpose your personal preferences on your evaluation of a company’s vulnerability to substitutes.

**Evaluating Competition in the Client’s Market**

Understanding how a company competes and who their competition is will help you evaluate the creditworthiness of your customer and anticipate potential external influences on the future performance of the company. It is important to profile market competitors and their approaches to winning market share, and then to evaluate that information in the context of your client’s market share and share potential.
Profiling Market Competitors

The issues to consider when evaluating market competitors are as follows:

• Who are the company’s competitors?
  ➢ To answer this question you must establish what industry your customer is in. Many companies have suffered because they were unsure what business they were actually in (i.e. Is your customer in the trucking business or the material movement business?).

• How many competitors are there? How strong are they financially?

• How do the companies in the industry differentiate themselves?

• Does your customer compete on:
  ➢ Price—low cost provider or “snob appeal” of high prices?
  ➢ Quality—initial quality and performance guarantee?
  ➢ Marketing—how does the company appeal to the consumer (packaging, advertising, rebates, etc.)?
  ➢ Distribution—reliability and speed?
  ➢ Returns and Allowance Policy—“no ask” return policy?
  ➢ Research and Development—cutting edge technology?
  ➢ Training—product and application knowledge?
  ➢ Convenience—outlet location, home delivery?

• Is your customer a wholesaler or broker and therefore subject to all the vulnerabilities of a middleman?

• Does the company “own” or control the ultimate customer?

• How does the potential for substitutes affect the company’s strategic plan?

• Is your customer a market leader or a market follower? Does the stated strategy imply one thing and the tactics tell a different story? How aggressive is the company’s management?

• Does it compete on size alone—either large (regional, national, or international) or small (niche)?

Large, well-financed competitors may have more ability to compete on price and more resources to enhance product quality or service. The best strategy for a small company might be to find a market niche (also called a concentration) in which bigger companies are not interested or cannot market to economically.
Weak competitors might actually give the product or service a bad name with customers, so a small company’s best strategy might be to distinguish the quality of its product, its punctual delivery schedule or superior customer service available after the purchase.

Companies that function as middlemen (wholesalers, manufacturer’s representatives, franchisers, etc.) are vulnerable to being eliminated by their customers or by their suppliers whenever those parties believe they could profit by performing your customers’ functions themselves.

**Putting Competition in the Context of the Market**

You should also ask questions about your customer’s market share. These include:

- How large is the total market?
- What is the company’s percentage of the total market?
- Is the total market growing, remaining static or declining?
- Is the market international or just domestic in scope?
- Are there many customers in the market place or just a few?
- What factors contribute to changes in the marketplace?

Companies that have a large market share usually have advantages that their competitors find hard to overcome, such as:

- Their size alone can give them better purchasing power with suppliers.
- They enjoy lower fixed costs relative to their sales and therefore make attractive profits on incremental sales.
- They may be able to withstand price competition or to initiate a “price war” against a smaller or new competitor. Companies that have low market share face the difficult task of taking business away from established competitors to build their sales, unless the overall market is growing rapidly.
Dimension 2: Assessing Management’s Ability to Formulate and Execute Business and Financial Strategies
**Purpose of Dimension 2**

The purpose of Dimension 2 is to provide tools and insights to support evaluation of a client’s management and management’s ability to formulate and execute business and financial strategies.

Key topics in this Dimension are:

- Management Qualifications
- Management Experience
- Management Integrity
- Management Organization Style and Characteristics
- Planning and Control Systems
- Information Technology Systems
- Shareholder/Management Relationship
- Using Third Party Information in the Management Assessment

**Management Qualifications**

Just as you have expectations about the characteristics of financial statements of companies in different industries, because of your own knowledge and experience, you have an idea of what skills are necessary to effectively operate the business to which you are lending money. Skills and knowledge, coupled with an effective management style and uncompromising ethics, will generally ensure the success of a company.

Core competencies required to successfully manage a company include Finance, Production, Distribution, Sales, Marketing, Research and development, Technology, Operations, and Human Resources.

All of these core competencies (with perhaps the exception of manufacturing and distribution in the case of retail companies or service companies) have to exist in some form or another within the company’s management team or its outside advisors such as accountants, lawyers and bankers. These skills will have different emphasis and degrees of importance depending on the company and industry. You need to determine which skill sets are necessary for success. Then you must determine which managers possess those skills and assess how vulnerable the company is to losing the manager(s) with those critical skill sets. Part of your evaluation is to determine whether management acquired skills through:

- **Formal education**
  
  What academic degrees or other evidence of formal training are necessary to demonstrate the existence of particular skills and knowledge?

- **“On the Job Training” (OJT)**
  
  What “on the job” technical and knowledge based training has been acquired in these areas?
In addition to comparing required core competencies with existing skill sets possessed by management, you need to assess the ability and willingness of management to learn new skills when business requirements change. This can be evidenced by continued education, attending seminars, and an attitude of “learning whatever is necessary” to keep the company moving forward. Make sure your customer is keeping pace with the industry.

Required skills fit into three categories:

- **Technical**
  
  Those core competency based skills upon which the company is founded, be it engineering, accounting, legal, chemistry, etc.

- **Organizational**
  
  How does management organize the core competencies required so that the company functions efficiently? Are there current organization charts and job descriptions that reflect the needs of the organization and the strategic plan?

  Is there evidence of orderly workflow and even distribution of work without bottlenecks?

- **Management**
  
  What is the management style that blends the technical knowledge and the organizational structure and delivers the product or service to the marketplace?

A deficiency in any one of these areas can compromise the potential of a company. Many companies have been started by very intelligent people, but have subsequently gone out of business because they didn’t possess either the organizational or the people skills necessary to operate a successful business. For all categories of required skills, it is important to ask the following questions:

- Is there an adequate supply of properly trained personnel?
- What is the rate of employee turnover?
- What are the hiring, advancement, and firing practices?
- What kinds of training are necessary?
- Is there a back-up plan (succession) for key functions?
- Is there a human resources function within the company and does it have complete personnel files, employee manuals, and policies that reflect current labor laws?

**Management Experience**

It is vital to profile the manage team’s depth of experience and skills, both to understand current management strengths and weaknesses and to determine if there is backup for the critical management skills needed to operate the business.

It is especially important when evaluating the CEO to ascertain how he/she compensates for his/her own deficiencies. Your goal is to understand how the CEO manages the strengths and weaknesses of the company’s management team. Through the interviews and your own observations, develop answers to these key questions:
• What is the experience of each key manager, and how does that experience relate to the core competencies required by the job? If a manager’s skills are not perfectly matched to the requirements, how transferable are the existing skills and experience to the profile of required skills? Is there a track record of willingness and energy on management’s part to acquire new skills and experience?

• Do senior managers have the experience and skills to appreciate the impact of the other people in the company who deliver the other core competencies? Being willing to work in a team environment is an excellent attribute, but the manager must also have the experience and working knowledge of the other disciplines to be truly effective.

• Have the managers been successful at adapting to change? How flexible is the management team to take advantage of opportunities or to make difficult decisions in light of challenges to the success of the company? Phrase this question in a way that prompts your interviewees to show specific examples, saying: Tell me about a time when you had to alter the company’s course to respond to an unexpected turn of events.

• Has the company weathered any adverse circumstances or severe economic cycles? Experience responding to a variety of economic conditions is a success factor. Evidence of effective, ethical behavior in times of crisis or adverse circumstances is a success factor.

• Is the company in the same business with the same management and ownership it had when it faced those hardships?

• Has the management team grown in experience and skill to match the evolving size and complexity of the business? A large company with multiple business lines has more complex management needs than a smaller, one-business enterprise. Ask senior managers to describe how the company has grown (internal growth, merger, acquisition?) and how each stage of growth altered the management profile. Ask each key manager to identify the skill or expertise they would be most likely to recruit for if able to add one more manager to the team.

• Has management exhibited a creative track record of developing new products and services? Ask key managers to describe the process that resulted in the most recent additions to their product or service. Ask them to explain what has historically motivated the decision to expand the product suite, such as response to competition, desire to be the innovative market player, or request from an existing customer.

• Have they managed at all levels of a fully integrated labor force? Do they have experience with establishing compensation and benefit programs that attract, retain and grow qualified employees? Do they possess the necessary experience with organized labor, if applicable?

• If the customer is a family owned enterprise, to what extent does the family control management decision-making? Has the family brought in outside, professional managers to supplement or succeed family management? Have family managers had meaningful and relevant professional experience outside the family business, to bring outside skills and perspectives into the business?

• Does the customer have a formal succession plan in place for key managers, and is the plan in active implementation? A company’s succession plan is vital to assuring you of some management continuity in the event of death, retirement or departure of a key manager. In addition, a customer’s commitment to succession planning provides business benefits to the company. Companies that plan for succession are identifying
The abilities and qualities needed for individuals to succeed, meaning they are pursuing a management development strategy instead of simply reacting to employment needs. Companies that actively communicate advancement criteria may benefit through higher manager retention. Qualities of an effective succession plan include:

♦ The company identifies its next leader in advance and communicates the choice of ‘heir apparent’ to others inside and outside the company. As a result, the new leader has valuable time to adjust and to prepare for the new duties, others have time to adjust to the new structure, and there is continuity for outsiders such as vendors, bankers and customers.

♦ The company has a formal approach to developing successor family members’ or employees’ operational, technical, interpersonal and financial skills needed to run the business.

♦ Individuals not designated as successor, as well as other key employees, professionally respect the designated successors; customers and suppliers believe the designated successor(s) will adequately replace the current leader.

♦ In a family owned business, the company provides compensation and other performance-based incentives for key non-family members to remain loyal despite not being eligible for family designated top management positions.

♦ There is a plan in place to fund the senior owner’s retirement and for transferring business ownership in a way that does not excessively leverage the company. In addition to the balance sheet benefits of this approach, this strategy can help allay an elder manager/owner’s reluctance to step down by minimizing fears that the transition will impair company financial strength, the elder’s retirement resources, or both. If the company must be sold to facilitate a generational transition, there is a successor financing strategy defined in advance. If the buyer is likely to be a third party, the customer (or customer’s family) has already determined who will identify, profile and pre-qualify prospective buyers, and who will be responsible for negotiating and managing the transaction. If the company is to be sold to existing family/partners/employees, a formal buyout plan is already in place.

♦ The plan is being implemented, even if identified only as a contingency plan. In other words:
  − designated successors or successor candidates are subject to performance reviews that include measuring progress in preparing for the next role;
  − the plan is reviewed at least annually by key managers and board members to ensure it continues to be relevant to current circumstances;
  − the company checks periodically to ensure that any designated plans for buyout financing are still feasible.

• Has management successfully employed outside advisors such as accountants, lawyers, and strategic planners to advise them in the core competencies? Recognizing a management deficiency is only half the battle; management must know how to use internal and external personnel resources to fill the skill voids.

• Have they demonstrated the mental toughness to defend themselves against internal or external threats to the success of their business?
Management Integrity

The assessment results of all areas of risk within a company can be positive, but if management does not possess the level of integrity necessary to make you and your institution feel comfortable, then the relationship should not be established even if you are secured by cash. Previously, you have been evaluating risk factors affecting the capacity of a company to pay. In assessing management risk, you will also address the issue of willingness to repay your debt. Many of the other risk assessment criteria are intellectual and formula-based evaluations, whereas the analysis of management is centered around your experience in dealing with people and your ability to “read people” as to their abilities and their ethics. The issue of owner managers versus professional managers instills nuances to the assessment process, but does not change the fundamental management questions. The issue of integrity encompasses the following:

- Honesty

  Does the individual lie, cheat, steal, or misrepresent facts? Does the individual tell you the “whole story” when asked to respond to a question? Be careful, however, not to confuse unwillingness to respond to your questions with fear of responding. Some managers are reluctant to share business difficulties with their lender, fearing the lender will apply uncomfortable additional scrutiny to financial statements and business decisions. The best strategy to prevent confusing dishonest omissions with fear of disclosure is to develop a close rapport with the customer, aiming for a relationship founded on mutual trust. Key to developing that rapport is remembering to conduct management interviews and conversations with an approach that does not place the manager on the defensive. It should instead emphasize your need to understand many dimensions of the company’s performance so you and your institution can play a collaborative, partnering role in the customer’s success.

  Consider also the accuracy of financial reporting. Reporting that is frequently amended or revised, or that is wildly inconsistent from period to period may suggest a lack of reporting controls that can introduce opportunities for fraud. Remember that although the senior manager of the company sets the tone for integrity, fraud can take place at all levels within the organization, and it is management’s responsibility to ensure that controls and monitoring systems are in place that will protect the company (and the lender) from malfeasance.

- Reputation

  Does the management team individually and collectively have a good reputation inside and outside the company? Does this reputation waiver in bad times, or do they try to do the right thing under all circumstances? Reputation is something that is earned over a long period of time, but can be shattered with one bad decision.

- Litigation

  Does the company or any of its principals have a history of litigation? Individuals who are quick to sue for personal reasons may transfer that behavior to the job. Also, carefully evaluate the nature and scope of lawsuits levied against the company. It is certainly true that a company can be sued without merit, and some industries, such as tobacco and alcohol products, are understood to incur significant litigation risk. However, if a customer is a chronic target of lawsuits, it is wise to investigate the frequency,
reasons and outcomes of the litigation to determine if litigants have legitimately needed to use the courts to elicit appropriate corporate behavior.

- Conflicts of interest

Is there an environment of true independence on the part of board of directors and outside advisors? You should evaluate the effectiveness of the customer’s board of directors for this and other reasons. See the discussion of board effectiveness that appears later in this Dimension.

You can ascertain the answers to these questions through your own personal observations and by checking with industry associations, community groups, and other centers of influence. Sometimes it is difficult to document, but a gut feeling that is making you queasy should be a warning signal to proceed very cautiously. By walking around a company’s manufacturing plant or administrative office, you can develop a sense for the respect that management has from the employees. Respect for an individual is generally a fair indicator of good ethics. Also follow your institution’s guidelines for accessing third party information through review of public records, credit bureau reports, peer reports and references from the community. These can be valuable resources for detecting hints of compromised integrity, or of course an overt history of criminal convictions. For a discussion of how to use the most common third party information sources, see the section titled Using Third Party Information in the Management Assessment, located at the end of Dimension 2.

**Management Organization Style and Characteristics**

How a company is managed is critical to its financial success and ultimately its ability to repay debt. All management teams, collectively and individually, have flaws. As the lender you need to recognize these flaws and address their impact on the company. These flaws may exist with the person with whom you have the relationship, so the discussion can sometimes become sensitive, but nonetheless very important. Some useful questions to pose to management are:

- Does management effectively anticipate outside influences? How do they react to unplanned situations? Ask for specific examples of how management responded in the past to unexpected events, both internal and external.

- Does management regularly conduct a SWOT analysis—a review of their Strengths, Weaknesses, Opportunities, and Threats? This activity requires management to step out of their day-to-day focus and forces them to look at the “big picture.”

- Does the company have contingency plans in place, at least for the most critical areas of the business? Contingency plans should provide clear guidance for response to business interruption, including relocation of assets or access to alternate physical plant; chain of command for decisions, including procedures when key managers are incapacitated or unavailable; and a communications plan to ensure the contingency plan can be communicated and executed.

- Does management exercise control at the critical points and with the appropriate amount of authority? In your management interviews, ask several senior managers to share with
you examples of when and how the management team has made hard personnel decisions to correct management behavior or remediate poor management decisions. Your goal in this discussion is to determine if managers are decisive, proactive managers of people, or if they are more likely laissez-faire managers reluctant to intervene, or ‘rock the boat.’ This discussion also gives you an opportunity to assess the practical function of management’s decision-making organization. If it is not clear who has responsibility for key personnel hiring/firing decisions, the customer’s ability to respond quickly and appropriately to internal or external problems is in doubt.

• Has a management succession plan been developed for the company? Be sure to review the management succession plan evaluation points included earlier in the Management Experience discussion.

• Is there an effective management organization in place? You should review and discuss with management the formal leadership organization in place, to understand the designated chain of command for key decisions. Within this discussion, watch for pitfalls such as:
  ♦ Inadequate use of the board (or no outside board).
  ♦ An organization that is too flat, limiting the development of competent functional management.
  ♦ An organization with too few functional managers. Senior managers may be stretched too thinly, or they may be managing and making decisions well outside their expertise.
  ♦ An organization that is suited to plan either operationally or strategically, but not both. Organizations with strong functional managers may excel at operations management and budgeting, but lack the vision and market focus to plan for strategic change. An organization driven and controlled by a strong marketing manager may lack the knowledge, focus or discipline for effective operational planning and plan execution. Both planning dimensions are needed for companies of virtually any size.
  ♦ An organization that has inadequate financial management infrastructure. As companies grow, it is common for the financial organization to evolve from a bookkeeping function to a controller function, and then to be augmented with treasury and ultimately chief financial officer functions. The treasury and CFO functions typically arise when the company’s capital needs become complex and must be satisfied with a variety of external sources. A company that has an undersized financial management organization may be missing growth opportunities for lack of access to capital, and it may also be susceptible to poor financial decision-making (such as pricing strategy) based on a poor understanding of critical financial functions such as cost accounting. Compare your customer’s financial organization with similar sized companies in compatible industries to help determine if the financial organization is adequate.

• Are the individual managers’ leadership and decision-making styles functional and appropriate to the size and complexity of the business? The impact of an individual’s management style on interpersonal skills and relationships has implications for both internal management success as well as success in external negotiations with suppliers, customers, regulators, and of course, lenders. To assess management styles and their effectiveness requires meeting with key managers individually and in groups, both asking
targeted questions and simply observing how the managers interact. Consider asking individuals to describe management styles of others on the management team, and look for common themes as you compare notes from the diverse interviews. There is no ‘correct’ management style, but be aware of signals that management styles may be dysfunctional:

♦ Visible tension in the room when one individual takes the floor, particularly when the discussion topic is sensitive.

♦ Appearance of in-fighting, fiefdoms or power struggles. When your interviews with separate managers suggest alignments with senior managers that fall outside the formal organization chart, probe deeper to try to learn if decisions are being made outside the formal chain of command.

♦ Surprising lack of information sharing. Lenders often ask interview questions that assume the interviewee has access to relevant information, such as recent financial results. Investigate further if you believe a manager’s function suggests he or she has access to the information, but the manager tells you or implies that they do not. If key information is controlled by one individual, there may be an autocratic manager running the business or a key function. Autocratic management styles can sometimes be effective in a crisis, but a more consensus-oriented style is generally more productive for a company’s long range performance.

♦ Also look for positive signs that your customer’s senior managers are effective leaders. Good personal leadership indicators include:
  ♦ Other individuals describe a manager as fair and ethical.
  ♦ In meetings, a manager encourages open discussion and debate.
  ♦ The manager has a strong track record of recruiting, developing and retaining very strong and effective colleagues and subordinates.
  ♦ The manager is regarded as open to new ideas and change.
  ♦ The manager supports training and development needs with commitments of both time and financial resources.
  ♦ A variety of stakeholders expresses a favorable opinion of their relationship with the manager, including employees, customers, suppliers, and board members.
**Planning and Control Systems**

In the following material there are several references to Sarbanes-Oxley (SOX), which is legislation in the U.S. focussed on financial and accounting disclosure. While SOX is not applicable to companies trading on Canadian stock exchanges, it is applicable to Canadian companies that are listed on U.S. stock exchanges and for Canadian subsidiaries of U.S. public companies. As many Canadian financial institutions do deal with these companies, references to SOX have not been deleted.

In Canada, while we have similar legislation for publicly traded companies listed on the Toronto Stock Exchange (TSE), the rules are not as far-reaching as those in the U.S. Instruments issued by the TSE require compliance by any company trading on the Exchange, with National Instruments (NI) having been accepted by the Securities Commissions in all jurisdictions and Multi-Lateral Instruments (MI) in only some. There is a move at this time to have these instruments issued by the Canadian Securities Administration, rather than the TSE. One of the primary differences between the U.S. and Canada is that the U.S. requires an independent audit of internal controls and procedures and Canada does not.

Securities legislation in Canada that provide similar protection to SOX include:

- MI 52-109 Certification of Disclosure in Issuers’ Annual and Interim Filings, which requires that a management officer who is a chief financial officer and a chief financial officer (or an individual who performs similar duties) certify that the financial results fairly represent the financial conditions, results of operations and cash flows for the period.

- Multi-Lateral Instrument MI 52-110 Audit Committees, which requires that every member of the Audit Committee be an independent Board member and be “financially literate” as defined therein.

- National Instrument NI 58-201 Corporate Governance Guidelines, which requires that a majority of the members of a board be independent and outlines several other requirements that a board “should have”.

- Multi-Lateral Instrument MI 58-201 Disclosure of Corporate Governance Practices, which requires reporting companies to detail in the Annual Information Form which requirements outlined in NI 58-201 the company is in compliance with.

**ASSESSING STRATEGIC PLANNING ABILITY**

It is essential to determine whether business and strategic planning are formal disciplines within the company. Questions to consider are:

- Is there a “working” long-term strategic plan with components for each functional area of the company (Finance, Sales, Marketing, Production, Distribution, Operations, Human Resources)?

- Does the plan outline relevant business risks and how the company proposes to respond to them? If there is not a formal written plan document that is updated at least annually, that does not necessarily mean that the company is not engaged in effective strategic planning. In the absence of a written plan, it is your responsibility to make effective use
of management interviews to understand the company’s strategic direction and decision-making approach.

The goal of your interviews should be to determine if management understands its market, including customer base, suppliers, and the competitive environment. You also must determine if management understands and responds appropriately to business and industry risks.

Maximizing the Value of Your Interviews about Business Strategy

In Dimension 1, we discussed how to profile these issues for an industry. When interviewing your customer on the specific opportunities and risks they face, consider the following suggestions for maximizing the value of your interviews:

- Elevate the discussion beyond simple who/what/where questions. For example, your customer may tell you that a critical risk in the industry is losing control of costs for a product that needs to be top of the line, but also competitively priced to retain market share. You certainly need to ask for the ‘facts’ of the product in question, such as what it is, how it works, current costs to produce and the price range it sells for. However, you should dig deeper by asking questions that require manager to interpret and to draw conclusions about cause and effect: what would happen if a major supplier increased prices by 10%? What would be your choices in how to respond, and which direction would you most likely pursue? How would your competitors be affected by changing supply costs, and how would you expect them to respond?

- Validate the manager’s response to your questions about strategy by asking for specific examples of strategies that worked, and that did not work in the past. To continue our example, ask the manager to tell you about a time when there was a need to increase a product price to cover growing costs, and how the customers and competitors reacted.

- Prepare your questions in advance, and ask to schedule a specific meeting to learn about the customer’s strategic vision and plans. Preview some of the topics you’d like to cover to allow the manager to think in advance about the answers. This approach will help avoid putting management on the defensive. Ask the manager up front to share his or her greatest concerns about managing the business in the future, and be sure to include those concerns in your questions and discussions about company strategy.

- Think carefully about what you’re being told in the strategy interview. Is this company merely responding to change or are they planning for it? Does management take note of and understand the moves of competitors? Are they applying creative solutions in response to competitive challenges?

Evaluating the Strategic Plan’s Effectiveness

Evaluating a strategic plan’s effectiveness involves not only comparing plans with actual business outcomes, but also finding out the extent to which company employees are involved in the planning process. A company’s ability to successfully execute a business plan is greatly enhanced when participation—and thus plan ‘buy-in’ is widespread. Consider the following questions as you discuss planning effectiveness with your customer:

- Is there evidence that planning has been fruitful in the past? Evaluate management’s presentations of prior plans (or discussions of them if no formal documents exist) by analyzing financial performance for relevant time periods. Look especially at appropriate
time periods to validate answers to your questions about specific strategies that have been tried in the past.

• How often is the strategic plan re-evaluated for relevancy and focus?

• Are policies and goals, established by the strategic plan and other directives, communicated to employees?

• Do employees get routine feedback about the company's results?

• Do managers and supervisors meet regularly to compare individual employee performance with stated goals and discuss the effects of external/internal trends or events?

• Is there a reliable, continuous and “safe” system in place for employee feedback to management? Pay particular attention to the existence of mechanisms for employees to safely report internal malfeasance. If the company is public, in the U.S. Sarbanes Oxley requirements ensure that whistleblower protections have been installed and similar legislation is currently being developed in Canada. In a private company, whistleblowers most likely enjoy legal protections, but it is less certain that whistle–blowing mechanisms have been created and communicated to employees. You need to ask about these mechanisms when interviewing senior management of private companies, and it is wise to ask the question of several individuals.

You should review with management any meaningful deviations from plan, meeting routinely with management as you monitor the relationship.

ASSESSING COMPANY CONTROL POINTS

You also need to depend on several company imposed control points in order to be comfortable with the financial and management integrity of the company. These control points are also the company’s mechanism for monitoring its progress and adherence to business plans.

In your overall assessment of management, look in the following areas to assess control points: Board of directors, auditors, company history, and inspection and licensing organizations.

BOARD OF DIRECTORS

The most effective boards of directors provide many dimensions of management support. Ideally, an effective board is truly independent and looking after the interests of the shareholders, especially in a public company. In a private company, the board’s role may be less clear, although the ideal board nonetheless should offer an independent perspective and have a voice in company decision-making. To assess the effectiveness of a company's board, you need to understand the roles and responsibilities of the board and how these are managed and implemented. In publicly traded companies the following information is a requirement in the Annual Information statement from management. In private companies, while meeting with Board members would be beneficial, it is often not practical. Senior management of the company should be in a position to answer the following questions:
• Is the board a working board, where members meet often and actively participate in strategic discussions and direct company managers to follow specific courses of action? Less effective boards meet fewer times per year to receive status reports, offering little guidance unless serious problems surface that require emergency attention. Ineffective boards have no influence on the company at all, serving as ‘rubber stamp’ organizations. These boards may exist to satisfy, on paper, a lender’s requirement for outside input.

• Does the company have a formal plan for its board duties, including a statement of purpose, description of committees, and formal decision-making rules? Effective boards have mutually clear expectations. That is, the board members understand what is expected of them in terms of management and governance support, and company management understands exactly how and when they are accountable to the board. Less effective boards have few formal organizational guidelines and no clear decision-making responsibility. These may be advisory groups with little accountability for business outcomes, and to whom company management is in turn, not at all accountable.

• Do boards and their subcommittees capture detailed minutes of each meeting, and are these minutes formally reviewed and approved by meeting attendees? Effective boards and their committees hold themselves accountable for discussions and decisions by ensuring that meeting details are recorded and entered into the formal minute books of each body. Less effective boards and committees keep minimal records of discussions and decisions, which allows room for subsequent misunderstanding or even re-interpretation of board proceedings.

• Are board members recruited to complement and complete management’s experience and skills? As a company grows in size and complexity, it can gain access to experience and expertise through its board that the company might not be able to afford to pay for as full time management staff. Effective companies actively recruit board members to fill in skill gaps and to gain access to business wisdom. They identify skills and experience needed and mount a purposeful search for the most qualified board members. Less effective companies avoid recruiting board members that will challenge management’s perspectives or decisions.

• Does the company provide legal protections for its board, including directors’ insurance, to communicate their commitment to true board governance input and to facilitate the board members’ willingness to fully participate? Effective boards are willing to make decisions because they have a full understanding of their legal responsibilities as well as their protections. Less effective boards are reluctant to engage in decisions based on fear of litigation or from lack of understanding of the legal limits of their governance roles.

• Are board functions organized for maximum efficiency and effectiveness? Do company managers and board members fully prepare for board meetings, with formal meeting agendas supported by advance information? Less effective boards attend meetings with little or no advance agenda information, relying on in-meeting information as the basis for recommendations or decision-making.

• Is there a board performance evaluation mechanism in place? Ranging from simple attendance standards to formal performance assessment criteria, the most effective boards assess their performance regularly, including taking periodic ‘time outs’ for the board to focus on and improve its own standards for effectiveness. Less effective boards engage in little or no self-evaluation, which can be a strong signal that the board actually enjoys little or no independence from management.
• If the company is small, and/or a family enterprise, has the company used outside consulting services to help develop an effective board, including help with board design and education? Higher performance private/family companies recognize the need for a well designed, effective outside management voice that a strong board can provide. However, the company may have difficulty achieving consensus on board design and composition when family agendas are not uniform. Well managed companies may choose to pay for outside board consulting to initiate the board function or to improve its effectiveness as the company’s governance needs grow.

Understanding the role of your customer’s board through interviews that cover these topics will help you ascertain how helpful they could be in protecting your institution's interests. A strong board will be comprised of individuals whose skills and experience complement your customer’s management team, and will have formal decision-making input. The board’s combination of skill and voice can considerably enhance the likelihood your customer will recognize and successfully navigate daily business risks as well as unforeseen changes to its operating environment.

AUDITORS

• Are the Auditors truly independent and qualified to conduct the Audit? In Canada the CICA has rules which apply to companies that are publicly-traded entities and have sales, market capitalization or assets greater than $10 million. These rules preclude auditors from undertaking any other position with a company that could be perceived to be a conflict of interest. A public company subject to Sarbanes-Oxley rules must comply with strict independence requirements in the U.S. Although private companies are not subject to Sarbanes-Oxley, the auditing profession itself is now governed by heightened independence standards. Canadian companies that trade on the New York Stock Exchange or subsidiaries of U.S. companies residing in Canada are subject to Sarbanes-Oxley legislation.

Auditor qualification is much more difficult to assess. The size and complexity of the customer suggests whether a large regional, national, or local firm is the best choice to meet the company’s audit needs. National firms engaged in auditing in Canada are subject to three levels of peer review – internal, Provincial Chapters of the CICA and the Canadian Public Accountability Board. While these peer reviews are not generally available for review, they do provide comfort with respect to the company’s ability to perform the audit function.

• Has the auditor issued a management letter to the customer? Under generally accepted auditing standards, auditors are encouraged to report concerns regarding a company’s internal control structure noted during an audit, and they are required to report certain of those concerns. Issues that are required to be reported are significant deficiencies in the design or operation of the internal control structure that, in the auditor’s judgment, could adversely affect the company’s ability to record, process, summarize and report financial data consistent with the management’s presentation of information in the financial statements.

Auditors’ management letters always point out that the audit may not have discovered all internal control deficiencies, but if the customer has engaged an audit, the audit procedures will provide a degree of assessment of internal controls that would not otherwise be available. Keep in mind that review and compilation engagements do not include the requirement for a management letter and are much less likely to uncover material control flaws.
Ask to see the management letter if one is available, and also find out if the management letter was presented to the company’s board of directors with a formal response to each control issue noted. If there is no board of directors or advisory board to review the management letter, ask the managers/owners of the company to explain how they remediated the control issues.

Companies are often reluctant to provide this information and if that is the case, discuss their reasons to try to understand why. If the company does not engage an audit that would result in a management letter, consider strategies such as requiring audit-level procedures only on accounts you are taking as collateral, such as receivables or inventory.

**COMPANY HISTORY**

- Any activity or result that varies from historic results can be a critical control point for you. Meaningful changes to the company’s historic pattern of conducting its business should be reviewed with management immediately.

- Carefully evaluate the customer’s prior attainment of its business plan, comparing stated goals and objectives to subsequent business results. Your review of actual performance compared to objectives provides you with insight about the credibility of management’s current plans. Moreover, it provides an important test of management’s own control systems: have they demonstrated the ability to monitor their own goal attainment and to take timely and appropriate steps to change course when needed?

**INSPECTION AND LICENSING ORGANIZATIONS**

- Any outside agency or group that must perform inspections or audits is a good source for information that might not otherwise surface. You should require copies of the documentation of these inspections and audits as a part of your loan documentation.

- institution a great deal of money by being a good listener at a social event.

**Information Technology Systems**

The purpose of interviewing a borrower’s management about information technology (IT) is to:

- Learn the extent to which the company’s business processes rely on critical information technology systems.

- Understand the role that information technology plays in the company’s ability to compete in its industry, as well as how the company compares with its competitors in effective use of information technology.

- Identify the company’s information technology organization and determine if planning procedures are adequate to assess IT expansion/upgrade needs and to secure financial and human resources to meet those needs.
• Verify that company management has developed policies, procedures and plans to identify and manage the company's IT internal control and physical risks.

Following are questions to ask that will enable you to develop a basic profile of your customer’s information systems adequacy. In a large company, you should include the company’s Chief Information Officer (CIO) in the discussion, along with an appropriate financial officer such as treasurer and/or controller. In smaller companies, there may not be a designated CIO, and it is important to identify the individual whose duties include managing the IT function. Often this will be the company controller. In a very small business, the outside accountant may have a voice in the company’s IT choices, particularly if the information systems revolve principally around financial accounting. Companies of all sizes may outsource some or all of their information technology management to IT consulting firms.

CRITICAL BUSINESS PROCESSES’ RELIANCE ON INFORMATION TECHNOLOGY

Ask your customer: Which business processes rely on critical information technology support, and how have you determined these are the critical processes? Ask the customer to consider which of the following business processes have the most critical information technology design and maintenance requirements to ensure the answer is not limited to a narrow view of the enterprise:

• **Sales and marketing**, including selling, advertising, and product development.

• **Manufacturing**, including purchasing and receiving, product manufacture or assembly, packaging, shipping, quality control, and regulatory compliance.

• **Finance and accounting**, including controller functions (accounts receivable, accounts payable, credit and collections, payroll, fixed assets planning/purchasing, budgeting and forecasting, accounting/bookkeeping, travel expense reporting, internal financial reporting, tax compliance) and treasury functions (external financial reporting, debt and capital structure management, banking and cash management, insurance).

• **Customer relationship management**, including customer service and technical support.

• **Human resources**, including hiring and termination, benefits management, staffing and compensation analysis, workers compensation claims, training and development, and employee assessment.

• **Legal**, including litigation support, intellectual property and contract management.

• **Management and board functions**, including management policy development, administration of management and board meetings, and corporate governance committee, policies and procedures.

• **Plant and other infrastructure**, including facilities management, security, physical records management, distribution and logistics, and telecommunications.

• **Corporate communications**, including employee communications, investor and public relations.
• *Information systems*, including IT strategy and planning, systems implementation and integration (project management, software selection, software development), IT systems maintenance, network administration, disaster recovery planning, information and records management, and help desk.

Consider asking your customer to rank each business process according to the degree of dependence on information systems, using a scale of 1 to 3. Then, focus your discussion on each business process rated as highly dependent as you continue your interview.

**INFORMATION TECHNOLOGY AS A COMPETITIVE ADVANTAGE**

Ask your customer to describe how information technology provides a competitive advantage in their industry and market. Ask how the company compares to strong competitors in its use of information technology as a competitive tool.

Many growing businesses are quick to embrace physical technology change that has an obvious payback in terms of cost or efficiency. For example, bar-coded product labels long ago eliminated the need for retailers to individually price-ticket most merchandise. More recently, radio frequency identification tags are being embedded in products themselves, transmitting whole trailer loads of product and price details to a retailer’s receivers. Manufacturing technology is quick to evolve as well, with increasing robotics applications in many industry sectors. These kinds of technology upgrades are viewed as competitive essentials. However, not all companies view information technology as a source of key competitive advantage.

Many public companies have had to begrudgingly upgrade IT resources to ensure compliance with higher standards for financial reporting accuracy imposed by the CICA in Canada and Sarbanes-Oxley in the U.S. Many private companies have been nudged by outside auditors or lenders to adopt accuracy standards similar to those established for publicly-traded companies. As a result, it is likely that your customer will initially think of financial reporting when responding to questions about IT. However, it is important to probe for IT’s competitive advantage perspectives by returning to the previously identified business processes that have critical IT design and maintenance requirements.

For each identified business process, ask the customer to explain how the IT system in place helps the company compete, and ask which competitors, if any, have stronger IT capability. Engage the customer in a discussion of company plans to implement IT upgrades or changes that will enhance competitiveness. Likely areas of focus for many companies include quality control (defect analysis), customer relations management, investor and public relations. Larger companies are likely to mention enterprise-wide software, in which business processes throughout the enterprise are integrated into one comprehensive information system.

**INFORMATION TECHNOLOGY ORGANIZATION AND PLANNING PROCEDURES**

• Ask: How does your company make information technology decisions, and who is responsible for managing the IT systems? What is your process for identifying needed information technology upgrades or expansion and for prioritizing related financial and human resources?
Ask to develop a profile of the IT organization. In a very small company, IT may be the responsibility of the controller or the entrepreneur/owner. Larger companies will have a dedicated IT department or division. Small or large companies may outsource IT management.

As you discuss the company’s IT organization, ask questions that will help you determine:

- Are IT planning and decision-making integrated within the business planning process, or a secondary ‘afterthought’?

- Does the company have access to competent IT expertise, either in-house or outsourced?

- Who is responsible for auditing and certifying that adequate controls exist to protect financial reporting systems to enable certification under both CICA Guidelines and Sarbanes-Oxley?

- Are IT development and maintenance resources priorities consistent with the business processes’ critical IT needs, as identified earlier in the interview?

- Are the scope and formality of the IT organization consistent with the complexity of the enterprise?

**INFORMATION TECHNOLOGY INTERNAL CONTROLS AND RISK MANAGEMENT**

Ask your customer to describe specific steps the company has taken to ensure the integrity and reliability of automated systems that support the business processes, and that collect and report financial information.

As companies grow, management’s ability to monitor and control business activities becomes increasingly dependent on information systems. There must be sophisticated controls in place to ensure that management’s information is accurate (integrity) and protected from interruption and unauthorized access (reliability). Companies complying with Sarbanes-Oxley must document, control and secure business processes that directly and materially contribute to reported financial results, although this is not the case in Canada.

Use the following questions to help assess the borrower’s development of appropriate information controls ¹

- How would you describe your IT controls? If you have established a formal IT control framework, what process did you use to design it?

- How often do you require all your managers to step back from other duties and evaluate risks and controls within their scope of authority?

- Has each manager specifically:
  - Considered current and planned operational changes to evaluate risks to business processes and/or financial information?

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♦ Determined appropriate mitigating controls, and evaluated effectiveness of those controls for the identified risks?

♦ Established an effective monitoring process to verify the controls are working?

♦ Reported their assessment up the chain of command to the chief executive officer?

- Have the results of this management review process been reported to the audit committee of the board of directors?

- Have you or other senior managers personally reviewed and do you understand documents of all internal controls in place? These should include technical safeguards for key IT areas such as: software change management, password management, security of remote access, communication encryption, access controls, monitoring, auditing and reporting, network security, intrusion detection, prevention and firewalls, end user training and support.

- Are the company’s financial systems consolidated, or do you maintain multiple financial accounting systems? (Consolidated financial systems pose fewer control risks.)

- Has an independent party tested all internal controls, and if so, have you addressed any control issues identified in the test findings? Is there a board- or senior management-appointed project team to assist with the test process to validate management’s internal controls, and have test findings been reported to the audit committee?

- Describe the nature and scope of training you provide to staff with custody or access to company or customer records to ensure they understand their duties and responsibilities.

In addition to discussing the company’s internal IT controls, you should also ask your management contact to verify the company has formal procedures in place to ensure physical security of the IT resources, including protection from theft or damage through fire or other hazard. Finally, you should ask for information about the company’s business continuity plan, verifying there are procedures in place for disaster recovery. Ask about the chain of command to declare a disaster, notification of employees, existence and accessibility to backup systems, offsite IT recovery team, and communication plan for key outside contacts such as customers and vendors. Also ask if there are disaster recovery plan test procedures, and how often these tests are administered.

**Shareholder/Management Relationship**

As a lender to a company, you have a safety net: the equity provided by the shareholders. It is important to understand their ownership objectives. How shareholders exercise the control feature of ownership is important to you and needs to be addressed in your loan documentation. Are the owners involved in the business? If the owners are involved in the day-to-day operation of the business, and are qualified to be so, this is generally a success factor. When owners are not involved in the business (whether shareholders in public companies or passive equity investors in private companies), there is potential for managers to make business decisions to their own benefit instead of to maximize shareholder value. In public companies with widely held shares, shareholders are too dispersed to exert influence on managers and must rely on the board of directors to enforce their interests. NI 58-201, Corporate Governance Guidelines in Canada and Sarbanes-Oxley rules in the U.S. now
ensure that public company boards include directors who are truly independent of management. The related rules for auditor independence and information controls assure an independent supply of accurate information to shareholders, whose ability to 'walk with their feet' by selling shares introduces an indirect means of accountability to company managers.

Private companies are not subject to the requirement for independent directors, so owners not actively managing the business must rely on a board of directors whose composition is not subject to regulatory scrutiny. Many private companies have multiple owners with divergent objectives, and with a mix of active and passive owners. Family-owned businesses are especially prone to the active/passive ownership mix as ownership passes through generations. There can be significant risks to the business when owners disagree on the company’s vision, strategy and resource management. Natural conflicts between management and passive owners occur even when managers are also part owners. For example, a younger generation of managing owners may have a more aggressive risk appetite than the retired generation of owners, and disagreements (including withholding financial resources) can arise. In such a case, it is vital to determine what process the company and its owners have established for dispute resolution (common dispute resolution approaches are discussed later in this Dimension).

**ASSESSING ALIGNMENT OF OWNERS’ AND MANAGERS OBJECTIVES**

If the company is managed wholly or in part by non-owners, it is particularly important to ask questions about alignment of owners’ and managers’ objectives. In your management interviews, discuss the following topics to assess the compatibility of owners’ and managers’ objectives:

- Is the board of directors an independent, effective body that will govern company managers from the shareholders’ perspective?

  Earlier in this Dimension we suggested questions to ask about the effectiveness of the board. To determine if the board is sufficiently independent, consider the membership composition. An independent board is one that has a majority of members who are unrelated to management and have no business or other relationship with management or the company that could be perceived as interfering with their ability to act in the shareholders’ interests. In addition, if there is a dominant shareholder who can vote or control votes of a majority of shares, the board should include members who have no family or business relationships with that dominant shareholder, to play the role of ‘devil’s advocate’ on behalf of minority shareholders.

- Is there a free flow of information from managers to shareholders?

  Public companies must conform to many regulations that ensure that shareholders are informed of the risks of ownership, through financial reports and other public filings. Private companies with a mix of managing and passive owners may not provide adequate information to the passive owners, opening the company to costly minority shareholder litigation and potential business disruption as the dispute evolves. Generally, the greater the transparency of information between managers and owners, the less likely that shareholder/manager disputes will arise.

- Is there a formal executive compensation plan that is designed to align management behavior with the shareholders’ interests? Ask for details about compensation arrangements for the CEO and other key managers. Public companies publish
significant details in their regulatory filings, but these details will generally not be available for private companies unless you ask. Key questions to consider include:

♦ How was the plan established, and by whom? If the compensation program is to align management behavior with shareholders’ interests, the compensation plan should be developed with the help of outside compensation expertise, and under the direction of the company’s board of directors. There should be a board compensation committee comprised only of independent directors, responsible for developing and updating the plan, in accordance with the board’s performance objectives for the company.

♦ How often is the compensation plan reviewed, and by whom? Periodic review should be the responsibility of the board’s compensation committee, which should also have responsibility for reviewing the job performance of managers included in the plan. This committee’s duties should also extend to review of compensation philosophy, methods and specific programs for layers of management below the executive level.

♦ What are the plan’s characteristics? Effective executive compensation programs have a mix of elements designed to attract, motivate and retain managers who will drive the company’s success. Where some ownership is possible (such as a public company), there should be a balance between cash and stock compensation. For both public and private companies, a significant portion of the senior manager’s total compensation should be tied both to annual and long-term financial performance of the company and to the creation of shareholder value. There should be performance criteria that enable the board to distinguish strong management performers from weaker performers, and to compensate them accordingly.

The mix of compensation elements will naturally vary by company, with larger, more complex organizations employing more sophisticated compensation programs. For example, cash compensation can include salary and bonus. Long-term incentives can include stock options or grants of restricted stock, with additional conditions such as granting stock options only to managers who have used some portion of their cash compensation to increase their personal stock ownership (most likely in a public company). In private companies where professional managers will not have ownership opportunity, long-term incentives are more difficult to engineer. Absent a readily measurable market value for company equity, owners need to develop fair but challenging incentive measures to ensure that managers remain focused on the owners’ long-term performance objectives for the company. Pensions and other post-retirement benefits may be effective elements of a plan to incent long-term performance.

♦ Have the plan and the subject managers’ compensation levels been validated using comparable compensation study data? Studies are available that profile compensation and related business metrics for all but the smallest enterprises. These studies are generally available through engagement with compensation consulting companies, and the cost may be prohibitive for very small companies. However, if the data are available, comparison to like enterprises enables both you and your customer to determine if compensation of key managers is appropriate given not only the company’s market and industry, but also in light of its financial characteristics and capital needs. As an indicator of strategic performance,
comparisons also help determine if the company is paying a competitive amount that will help ensure executive management retention.

♦ Are there other forms of management compensation outside the formal plan? For example, loans to managers and personal use of company assets such as aircraft can be legal transactions if handled according to appropriate accounting policies. As you consider the appropriateness of management remuneration, it is important to understand the full compensation picture, asking the customer for help in quantifying the full amount if needed.

DETERMINING IF THERE IS A DISPUTE RESOLUTION MECHANISM IN PLACE

When a private company’s management and shareholders’ interests are not aligned, there is significant risk of costly shareholder disputes. Dissident shareholders, even minority shareholders, can be a significant distraction to management and keep them from focusing on their day-to-day strategic objectives. You should inquire about significant blocks of stock that, if sold to another party, could significantly alter the strategic direction of the company and could foretell a change in management. Also ask management to describe any formal dispute resolution processes that exist in the form of shareholder or partner agreements, to verify there is a mechanism to resolve disputes that avoids litigation.

A good shareholder or partner agreement should clearly define the shareholders/partners’ roles and responsibilities, as well as prescribe a method for separation of the shareholders/owners in the event of a dispute or other event. Ask if the customer’s shareholder/partner arrangements include such provisions as:

- Buy/sell agreement, describing the events and circumstances, such as termination or retirement, under which an owner may be required or allowed to sell shares/partner interests back to the corporation or other partners. Included in this agreement might be descriptions of the circumstances under which an owner may sell his/her interest to another, the method for valuing the owners shares or partner interest, and under what circumstances a departing owner may compete with the current business.

- Agreement outlining how the company will be operated when a majority owner retires or dies.

- Agreement specifying in advance how disputes will be resolved, including provision for mediation and arbitration, and the process for selecting the mediation or arbitration platform.

EVALUATING LIKELY FUTURE FINANCIAL COMMITMENT TO THE BUSINESS

A final perspective on understanding the relationship between management and owners, and especially the implication of that relationship for loan repayment risk, is to evaluate the owners’ likely commitment of additional financial resources to the company. Whether the resources are personal or institutional depends of course on the size and nature of the borrower. If the owners are willing and able to invest more money, certainly this is a success factor. However, keep in mind that the bank cannot rely on such additional investment potential without a legally enforceable commitment.

To evaluate the likelihood of additional financial support from owners, first identify the composition of the owner group. Determine if the bank has any prior experience with the
owner’s group. Specifically, find out how the owners responded to the company’s capital needs in the past.

For privately held companies, identify the owners and find out how they have supported the company during its business cycle. If there are venture capital sponsors, ask for information about their overall track record in supporting investments when they develop unexpected problems and related capital needs.

For publicly held companies, it is important to determine the mix of ownership and control by individuals, institutional investors and management. Maintaining a consistently growing stock price with a satisfactory return on investment is key to maintaining shareholder value.

**Using Third Party Information in the Management Assessment**

An essential component of due diligence in commercial lending is third party sources of information. By collecting information from outside sources such as banks, trade creditors and consumer and business credit bureaus, the bank not only obtains information needed for the credit decision, but also achieves these objectives:

- To help profile the customer’s willingness to repay, based on past payment behavior.
- To help discover integrity issues, including records of prior criminal behavior.

You should know how to access and interpret information from third party sources of information on businesses, owners and/or guarantors. Sources of information can include:

- **Business Credit Information**
  - Lending and depository institutions
  - Trade credit grantors
  - Factors and finance companies
  - Leasing companies
  - Business Credit Bureaus
  - Dun and Bradstreet
  - Industry specific organizations

- **Consumer Credit Bureaus**
  - Trans Union
  - Equifax

- **Other Third Party Resources**
  - Lien search companies
Better Business Bureaus

Court records

Criminal Background Investigations

A good rule of thumb for third party information requirements is to obtain at least one business credit report from a well known provider, consumer credit reports on each guarantor and significant owner (based on credit policy) and an additional lien search from an external, national public record search firm. With these and the customer supplied financial reports, information obtained from interviews and, at minimum, one business premise visit, you should have developed a sound knowledge with which to make your business credit decision.

BUSINESS CREDIT INFORMATION

Direct Exchange with Other Creditors

Authorization is not required to collect credit information on non individuals for business credit purposes, with few jurisdictional law exceptions. It is common practice for the business credit community to freely exchange business credit information (between banks or business credit grantors and banks) with the understanding that the use of the information is for legitimate business needs. Sources of information and names of inquiring parties are kept confidential and may not be disclosed without their permission. For more information on the exchange of business credit information see RMA’s Guidelines for the Exchange of Commercial Credit Information.

If a dual borrowing relationship exists with other lenders it is acceptable, and sometimes advisable, to contact banks directly for a recap of their credit experience. If you know the customer’s account officer, contacting that individual personally can often glean more current and accurate information, compared to a centralized credit reporting department. Either way you should expect to receive information about past borrowings, average balances on deposit and current amounts owed. You should also be prepared to share like information and the purpose of the inquiry with the responding bank. In this way a true exchange of information results and both banks can update their credit file material. RMA’s Guidelines for the Exchange of Commercial Information provides a detailed review of the process.

Business Credit Bureaus

Dun and Bradstreet is the largest provider of business credit information reports, but not the only one. Your financial institution will most likely have a list of available sources in your area. Credit reporting groups provide important information from external sources and often from the borrower itself. Business name, entity type, address information for places of business, Provincial or Federal registration information and principals’ names are provided. This allows the lender to verify information given in the credit application or during the applicant interview and positively identify the customer.

Included in these reports is public record information such as PPSA filings, suits, liens and bankruptcy filings. This information displays a history of events for the lender to analyze and compare to financial statement information disclosures about creditors and liabilities. You
can also quickly assess your bank’s own lien position relative to the collateral being offered by the borrower. If a PPSA is showing on the report for all assets now owned or hereafter acquired, you will know there may be issues with taking accounts receivable as collateral. If a mortgage has been recorded, you will understand that a first position on real estate is not possible, without paying off previous lenders.

Business credit reports include trade payment history. A lender should understand how the borrower handles its accounts payable. Are discounts taken? Are payment trends spiraling downward, indicating a potential cash flow problem? Are all purchases made from only one or two major suppliers giving rise to a concern about undue vendor concentrations? If so, what would happen if that source of product dries up or the customer is placed on a cash-only basis?

Business credit reports come in a wide variety of formats. Many reporting companies offer a summary credit rating. Some reports can be purchased in different formats that allow a price differential based on the amount of information provided.

Obtaining at least one business credit report from a third party source is important to help confirm identity and provide a basic overview of payment habits for the business. When combined with consumer reports on guarantors and direct credit inquiries with other lenders or creditors, the lender will have a good idea of the borrower’s payment trends.

**CONSUMER CREDIT INFORMATION**

To obtain consumer credit information on parties not personally liable for the debt such as third party collateral grantors, officers or directors, consent needs to be obtained in order to comply with Federal and Provincial Privacy Legislation. If possible, it is good practice to obtain a signed consent from any guarantor of business debt, although under certain circumstances a verbal consent is sufficient. Most financial institutions include consent language on personal financial statement forms required to be completed by individual borrowers and guarantors.

When reviewing consumer credit reports on guarantors and individual borrowers, the bank is looking for the amount of debt and payment trends. Also of importance are tax liens, bankruptcy notifications, judgments and other public record information that convey the subject’s ability and willingness to repay debt. Any derogatory information found on a consumer credit report provides a red flag for the lender and an indication that more in-depth analysis will be needed.

Indicative information is found on consumer credit reports such as name, address (past and present), social insurance number, telephone number, year and month of birth, and employment history. This information is used to verify identity and compare to information provided on credit applications. Security alerts or warning messages are also included. These provide the lender with a heads-up that some information on the report may be in conflict or needs special attention. This type of information generally indicates that further confirmation of identification is needed. Warning alerts include:

- Subject social insurance number does not match inquiry
- Irregular report/security warnings returned from Bureau
• Dispute in credit report
• Report contains a consumer statement
• Alias or former name shown in report
• File Variation
• Deceased flag on

A composite consumer credit score, total revolving and non-revolving exposure and total balances outstanding are displayed on a consumer credit report, along with the reporting company names. Consumer credit reports should be obtained on all individual borrowers and guarantors. It is rare that a direct inquiry to another creditor or bank is conducted on an individual. If a direct inquiry is done, usually an authorizing customer signature will be required by the respondent.

OTHER THIRD PARTY INFORMATION SOURCES

Lien search companies, provincial registries, Better Business Bureaus and court records are examples of additional resources available to augment the credit profile. Your financial institution has guidelines for when to initiate information searches through these kinds of resources. In addition, you should be familiar with the general contents of a criminal background investigation, which many financial institutions use to verify identities and to discover any prior criminal activity.

The purpose of a background investigation is to:

• Use an impartial fact-finding resource to help identify misrepresented identities.
• Help prevent unknowing participation in fraudulent business activity.
• Discover hints of potential unethical behavior.

If you are lending within your home market, you may know the borrower’s management personally, and your knowledge of the community may help you avoid unknowing business relationships with dishonest individuals. However, keep in mind that it is unlikely you can know all the key players in a company outside of your management interviews, and remember as well that those intent on fraud can construct a very believable façade of credibility. For these reasons, it can be advisable to obtain a background check on managers and owners of companies new to you or to the market.

The investigation may examine:

• local and federal court records for civil and criminal litigation.
• nationwide press records.
• financial/organized crime databases.
• federal exclusionary databases.
• PPSA filings, judgments, bankruptcies, and fictitious name filings on not only the corporation but also the principals.

• Securities Commissions disciplinary action search

The investigation can be more or less comprehensive, depending on the cost of the research. For example, a more costly comprehensive investigation typically includes:

• database searches

• reference, education, employment, resume & certification verification

• researchers’ visits to court houses, hand searching to verify identity accuracy

• newspaper story search, local, nationwide or worldwide.

An investigation is also available for a much lesser fee if performed by computer database-only searches. Accuracy of these investigations depends on accuracy of input; misspellings can create unknown or incorrect information. The most costly searches can include up to 20 years of history.

Keep in mind the two key limitations of criminal background investigations:

• A clear background check does not assure good management or even good ethics.

• The background check tells us history. It cannot accurately predict the future.

Some financial institutions perform these checks in-house using purchased databases. You should consult with your institution’s credit checking department to determine if your bank uses this investigative tool, as well as guidelines for transaction size or other parameters that may govern its use.
Dimension 3: Complete Accurate, On-going and Timely Financial Assessments of the Client and its Other Credit Sponsors
Purpose of Dimension 3

The purpose of Dimension 3 is to review analytical tools needed to perform a financial assessment of the borrowing client and its credit sponsors. Key topics in this Dimension are:

- Gathering and evaluating the quality of the financial data
- Accounting fundamentals
- Balance sheet analysis
- Balance sheet ratio analysis
- Income statement analysis
- Income statement ratio analysis
- Financial Efficiency Analysis
- Financial Productivity Analysis
- Classifying Accounts for Automated Spreading Systems
- Comparing Financial Performance to Industry Peers
- Personal financial statement analysis

Gathering and Evaluating the Quality of Financial Data

Appropriate financial information generally includes:

- Three years of year-end financial statements. The quality of financial statements required for a particular borrower will generally depend on the size of the credit facilities and the perceived risk. While the following guidelines are examples of those that may apply in a particular financial institution, audited statements will almost always be required when there is perceived to be a significant amount of risk.
  - For smaller companies and smaller credit exposures, signed tax returns may substitute for financial statements.
  - For credit exposures less than $1 million only Compiled (or Notice to Reader) statements or company-prepared financial statements are required. Company-prepared statements should be signed and dated by an officer of the company. When accepting a company-prepared financial statement, it is good practice to also require a signed tax return for each statement year.
  - Credit exposures less than $5 million may require Reviewed (or Review Engagement) financial statements
Credit exposures greater than $5MM may require audited financial statements.

As a condition of your credit, annual financial statements should be required no later than 90 days after the end of the fiscal year.

- Interim financial statements. Interim financial statements are almost always company prepared. When any request for new money is received, request interim financial statements as of the most recent quarter or month-end. In addition, if you are evaluating a request for seasonal financing, or if the customer is undergoing significant market or other change, it is generally prudent to request financial statements for the same period ended the previous year. This enables you to determine how the business has changed over the year.

It may be a requirement of your credit that your client submit monthly or quarterly financial statements in order to enable you to monitor ongoing results. These should be required no later than 30 days after the relevant month-end.

- Management budgets with projections. It is always preferable to have budgets and projections, but not always practical. If your client is looking to renew loans at the existing level and there has been no significant change in the performance or risk of the business and none is anticipated, it is probably not necessary to insist on projections. However, if the nature of the business has changed (or there is a plan to change the business), or the financial results are significantly better or worse than expected, a budget should be required, particularly if new money is being requested. The budget and projections should include detailed assumptions, to enable you to assess management’s logic and to prepare your own ‘devil’s advocate’ projections that test the company’s repayment ability in the event of a departure from planned financial and non-financial events. A budget, together with ongoing reporting, will also allow you to monitor results to determine if the company is achieving desired results.

The detail required (monthly, quarterly, annually) and the number of years will depend on the situation. For seasonal loans or for loans to companies with rapidly changing financial performance, you may require a monthly projected cash budget in addition to a projected income statement and balance sheet for the forecast year. If the requested increase is for fixed assets, you may want three years of projections to determine the appropriate amortization of the loan.

- Inventory and equipment schedules. If your loan is to be secured, inventory and equipment schedules provide the detail required to estimate collateral value, including determining if a formal collateral exam or equipment appraisal will be required. Inventory and equipment schedules should include details about acquisition dates and costs of classes of inventory, as well as cost, acquisition date and net book value of individual pieces of equipment or classes of equipment.

Provision of inventory and equipment schedules on an annual basis will also enable you to determine if there has been any significant change in the assets.

- Accounts receivable and accounts payable agings. If your loan is to be secured by accounts receivable, detailed aging, concentration, and bad debt provision information is required. Even if the loan is not going to be secured, aging and concentration information about both account debtors and creditors is needed to assess the quality of reported earnings as well as the accuracy of reported net worth. Receivable and payable agings and concentration reports also provide valuable insight into the borrower’s vulnerability to loss of customers or suppliers.
If operating loans are to be margined to receivables and/or receivables and inventory, a monthly aged listing of receivables and payables, as well as an inventory listing, should be requested to be provided within 20 days of month end.

- Personal financial statements and tax returns if applicable. Personal financial details are appropriate when personal guarantees are to be required for loan approval. Personal statements should be dated within 90 days prior to the loan approval date and it should be a requirement that they be updated annually, also within 90 days prior to the borrowing company's annual loan review date. Personal financial statements should be signed and dated by the submitting individual, and only the guarantor's assets/liabilities should be included on the financial statements. At minimum, assets owned jointly (such as with a spouse) should be noted as such. Substantial additional information about personal financial statements and tax returns is included later in Dimension 3.

The financial statement guidelines provided above are general guidelines that do not take into account differences in company or transaction risk. In addition, you should consult your own financial institution's guidelines that govern the nature, type and frequency of financial data required for analysis and loan approval, as well as the required type of independent assurance required (i.e. reviewed versus audited statements). An explanation of the different levels of financial statements is included in the Accounting Fundamentals discussion to follow.

**Knowing the Auditor**

All Chartered Accountants (CAs), Certified General Accountants (CGAs) or Certified Management Accountants (CMAs) in Canada or Certified Public Accountants (CPAs) in the United States do not possess the same qualifications and knowledge. If the quality of the financial information is suspect or the CA/CGA/CMA or CPA (together referred to as the “Auditors”) unreliable, then the basis on which you make a decision to lend is faulty. Questions to consider when evaluating the Auditor include:

- Who is the Auditor?
- Does the Auditor exist?
- Is the Auditor in good standing (by licensing board in its jurisdiction)?
- Does your financial institution have experience with the Auditor and, if so, what is the basis of that knowledge?
- How long has the Auditor been auditing your customer and what was the basis for the engagement?
- Is the Audit firm also doing consulting work for the client, and does that activity represent a conflict of interest that might cause the “numbers” to be compromised?  In Canada the CICA has rules which apply to companies that are publicly-traded entities and have sales, market capitalization or assets greater than $10 million. These rules preclude Auditors from undertaking any other position with a company that could be perceived to be a conflict of interest. A public company subject to Sarbanes-Oxley rules must comply with strict independence requirements in the U.S. Although private companies are not subject to Sarbanes-Oxley, the auditing profession itself is now governed by heightened independence standards. Canadian companies that trade on the New York Stock Exchange or subsidiaries of U.S. companies residing in Canada are subject to Sarbanes-Oxley legislation.
You should expect the Auditor to provide independent judgment and utility to the financial statements. It is this independent judgment, in conjunction with appropriate accounting standards and procedures that provides the credibility and reliability of the numbers.

FACTORS THAT AFFECT FINANCIAL STATEMENT RELIABILITY

In addition to the degree of compliance with Generally Accepted Accounting Principles (GAAP), there are other issues you should address to determine the reliability of financial statements:

• Qualification and Independence of the Auditor

• Integrity of the Issuer (Management)

• Relationship of the Financial Statement Date to the Company’s Operating Cycle

QUALIFICATIONS AND INDEPENDENCE OF THE AUDITOR

All Audits, even those with unqualified opinions, are not equally reliable.

Qualifications

Audits should be prepared by Auditors who are well trained and qualified to audit the company you are analyzing. Questions you should ask are:

• Does the Auditor exhibit the technical skills required to complete an Audit?

• What is the depth of the Auditor knowledge about your customer's industry?

• Is the Auditor firm adequately staffed to perform the Audit required if your customer has multiple subsidiaries and/or locations?

Independence

Evaluate the Auditor’s independence. The ability to render an independent opinion on the financial statements of your customer could be compromised, and the ability to insist on proper standards and disclosures could be severely tested if:

• The Auditor is a relative of management or the owners.

• The Auditor is a stockholder or creditor.

• Your customer’s account is one of the largest or most profitable accounts that the Auditor firm audits.

It is your job to include such conditions in the evaluation of financial statements. The lack of proper qualifications and independence erodes the quality and reliability of the financial statements.

INTEGRITY OF THE ISSUER (MANAGEMENT)

The preparation of the financial statements is the responsibility of management, even when audited with an unqualified opinion by an Auditor. It is not the primary purpose of an audit to discover all frauds or misrepresentations. However, audit procedures are intended to examine the adequacy of the company’s internal controls and to check the accuracy (even
on a sample basis) of the account balances. Most Auditors issue a Management Letter, to be disclosed at management’s discretion, that describes:

- Weakness of internal controls
- Suggestions for improvement of internal controls and integrity of management systems
- Appraisal of improvements made by management from the previous management letter

If the Audit exposes instances of actual manipulation or misapplication of funds or has insufficient information to provide an unqualified opinion, the Auditor must disclose its effect on the accuracy, fairness and consistency of the numbers. This discovery might lead to a:

- Qualified opinion
- Disclaimer of opinion or Refusal to Provide an Opinion
- Adverse opinion
- Resignation of the Auditor as auditor on your customer’s account if management will not address the problem satisfactorily.

The various Audit opinions are defined later in Dimension 3.

**RELATIONSHIP OF THE FINANCIAL STATEMENT DATE TO THE COMPANY’S OPERATING CYCLE**

Most companies have an annual low point that marks the closing of their business cycle. Toy stores, for instance, have their greatest volume of sales at Christmas. However, many companies set their year-end at December 31 or at some other arbitrary time, regardless of the actual business cycle low point. The important thing for you is to determine which part of the company’s cycle is reflected in the statements.

**Example:** Late January or February would be a logical time for a seasonal retail business to issue a year-end statement because the store has a low level of inventory, has collected on its Christmas sales, and paid its suppliers.

**Example:** A college or other educational institution typically has a June year-end that corresponds with the low point in that industry’s business cycle.

At a natural low point, the financial statement should appear at its most liquid, least indebted condition. A financial statement prepared nearer the peak of seasonal activity, such as December 1 in the retail business example, will show higher levels of inventory and accounts payable to suppliers or notes payable to banks to support those higher asset levels. You can work effectively with statements from low or peak periods and you need to understand both.

Interim financial statements will show you a snapshot of the company at various points in the annual business cycle. You should become knowledgeable and comfortable about the makeup of your customer’s asset structure at those different points in the business cycle.

**Accounting Fundamentals**

The following discussion of Accounting Fundamentals will review these concepts:

- Types of Auditor Prepared Accounting Documents
• Generally Accepted Accounting Principles (GAAP)

• Company-Prepared Financial Reports

**TYPES OF AUDITOR PREPARED ACCOUNTING DOCUMENTS**

There are three types of Auditor prepared documents that are particularly relevant to your analytical work.

• Engagement Letter

• Financial Statements

• Management Letter

*Engagement Letter*

This letter outlines the terms of the contract between the Auditor and your customer. It documents:

• The scope of the accounting services provided.

• The cost of the compilation or notice to reader/review engagement/Audit and any other ancillary services being provided at the time, such as tax preparation services or the filing of specific regulatory documents.

• The purpose for the preparation of the financial statements. For example, the statements may be prepared for tax purposes, review by credit providers or an intended sale of the company.

By reviewing a copy of the Engagement Letter, you will have a better understanding of what to expect from the accountant when you receive a copy of the Financial Statements.
Financial Statements

The Auditor’s Opinion states the extent of the Auditor’s examination. A major determinant of reliability (and the first thing you should question about financial statement quality) is the degree of assurance that the statements are prepared in accordance with GAAP. You identify the degree of assurance by examining whether the financial statements are audited and, if so, what type of opinion has been rendered. The chart below shows the most common types of financial statement opinion:

Auditor’s Opinion

Not all financial statements are prepared in accordance with GAAP, and it is important to understand how these financial statements (such as cash basis or modified cash basis) deviate from GAAP.

Fully Audited Financial Statements

Audited statements provide the highest level of assurance, although not all Audits are equally reliable and useful. “Audited” means that an Auditor has followed prescribed rules and procedures to verify the accuracy and validity of the numbers, including such tests as
counting the inventory and confirming the accounts receivable (even if such counting is on a sample basis).

With each Audit, the Auditor presents a letter that advises the reader of the scope and extent of the audit and expresses an opinion on the results. By reading the opinion and related footnotes and understanding the reason for any qualification, you can decide how much to rely on the financial statements. Opinion letters use a standard format to comment on:

- The application of GAAP
- The fairness and consistency of the statements
- Any exceptions

Four basic types of opinions can accompany audited financial statements. Each opinion with its features and reliability is listed below:

<table>
<thead>
<tr>
<th>TYPE</th>
<th>FEATURES</th>
<th>RELIABILITY</th>
</tr>
</thead>
</table>
| Unqualified        | Without any qualification, the audit has been performed according to generally accepted auditing standards, and the financial statements are prepared in accordance with GAAP.  
An explanatory paragraph, while not affecting the opinion, will be added under certain circumstances, including when an aspect of the company’s financial condition is uncertain or when there has been a material accounting change.  
Example: Opinion letters include explanatory paragraphs when there is uncertainty about the outcome of a lawsuit, the company changed its method of computing depreciation, or there is substantial doubt about the company’s ability to continue as a going concern. | Most reliable data to analyze.                       |
| Qualified          | Contains an exception or qualification described as “except for” when there is some departure from GAAP or when the scope of the audit has been limited.  
Example: A statement of cash flows is not presented, or accounts receivable or inventory have not been verified. | Depends on the nature of the qualification.  
**Example:** Absence of inventory verification is significant; a fully disclosed accounting change probably is not. |
<p>| Disclaimer or Refusal to Provide an Opinion | Auditor does not wish to express an opinion because there is not enough evidence to support an opinion.                                                                                                      | Casts serious doubt on reliability. It is important to investigate the reasons for refusal. |</p>
<table>
<thead>
<tr>
<th>Opinion</th>
<th>information to do so.</th>
<th>the disclaimer.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adverse</td>
<td>Departures from GAAP are too material to allow even a qualified opinion.</td>
<td>A definite red flag that could have significant bearing on creditworthiness.</td>
</tr>
</tbody>
</table>

**When to Require Audited Financial Statements**

After you identify the type of financial statement and its level of compliance with GAAP, decide if it is sufficiently reliable for your analysis of a particular company or credit opportunity. Often, you must decide when to require Audited Statements.

The following affects your decision about when to require Audited Statements:

- The degree of risk you find in the outstanding or proposed loan (including its size relative to your bank’s portfolio and relative to the size and apparent strength of the borrower). The riskier you judge the loan to be, the more likely you will require an Audit.

- Length of time a loan is expected to be outstanding. The longer the loan will be outstanding, the more likely you will require an Audit.

- When you have identified margins of protection within the financial information, you are more likely to require an Audit.

**Example:** If one of the favorable factors in a loan decision is that the loan will not be larger than about half the level of accounts receivable and inventory, you probably want a full, complete audit or special procedures to verify the level of accounts receivable and inventory.

**Example:** If your loan will be $50,000 and guaranteed by the owner of the company, who is wealthy, reputable, and well known to your financial institution, you may be able to accept a financial statement prepared on some basis other than an Audit. However, if your loan is $500,000 and the owner will not guarantee, or the guarantee does not give you much comfort, you would probably require an Audit.

There are many other financial reports you might require and other factors that would have an effect on your decision. The examples above illustrate only that the need for an Unqualified Audit is relative to risk and margin of protection.

**Unaudited Financial Statements**

Unaudited financial statements offer little or no assurance that they have been prepared in accordance with GAAP. They can be prepared by an Accountant or by the company issuing the financial statements. Preparation by an Accountant does not ensure financial statement reliability or compliance with GAAP. The accounting profession offers its clients two types of unaudited financial statements: Review (or Review Engagement) and Compilation (or Notice to Reader). The features and reliability of those two prepared statements as well as company-prepared and cash-basis statements are described in the following table:
<table>
<thead>
<tr>
<th>TYPE</th>
<th>FEATURES</th>
<th>RELIABILITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review or Review</td>
<td>Less in scope than an audit and provides only limited assurance that the</td>
<td>May be reliable for a particular analysis but not as an audit. Popular</td>
</tr>
<tr>
<td>Engagement</td>
<td>statement is prepared in accordance with GAAP. Some are expanded to</td>
<td>service with companies because of cost.</td>
</tr>
<tr>
<td></td>
<td>include specially requested tests of inventory or receivables.</td>
<td></td>
</tr>
<tr>
<td>Compilation or Notice</td>
<td>Contains few or no disclosures of accounting methods. No assurance of</td>
<td>Lenders must guard against the tendency to assume reliability because a</td>
</tr>
<tr>
<td>to Reader</td>
<td>compliance with GAAP.</td>
<td>financial statement is presented in a clear format with some apparent</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Accountant association. Reviews and compilations are not audits and do not</td>
</tr>
<tr>
<td></td>
<td></td>
<td>offer the assurance of objectivity, fairness, and consistency that audits</td>
</tr>
<tr>
<td></td>
<td></td>
<td>do.</td>
</tr>
<tr>
<td>Company Prepared</td>
<td>Prepared internally by the company. Even when statements are prepared</td>
<td>Least assurance of objectivity in the presentation of the numbers; most</td>
</tr>
<tr>
<td></td>
<td>by a well-trained person of high integrity and apparently detailed and</td>
<td>potential for undisclosed inconsistencies or departures from GAAP.</td>
</tr>
<tr>
<td></td>
<td>useful, they lack the independent verifications that a qualified outside</td>
<td></td>
</tr>
<tr>
<td></td>
<td>auditor can provide.</td>
<td></td>
</tr>
<tr>
<td>Cash Basis</td>
<td>Almost all tax returns and some company-prepared statements report cash</td>
<td>Do not disclose the full extent of a company’s resources or obligations</td>
</tr>
<tr>
<td></td>
<td>receipts and disbursements rather than accrued revenues and expenses.</td>
<td>and can give the user a false impression of profitability and economic</td>
</tr>
<tr>
<td></td>
<td></td>
<td>viability.</td>
</tr>
</tbody>
</table>

**Financial Information Required by GAAP to be Reported**

- **Statement of Financial Position (Balance Sheet)**

  The balance sheet outlines the financial position of the company as of a particular date. It reflects the basic accounting equation: **ASSETS = LIABILITIES + OWNER’S EQUITY**.

- **Income Statement**

  The income statement provides a summary of financial transactions for a particular time period (usually one year) ending with the date of the balance sheet.

- **Reconciliation of Net Worth (Owner’s Equity)**

  This key link between the income statement and balance sheet, it identifies and itemizes transactions affecting net worth during the period covered by the income statement.

- **Statement of Cash Flows**
This statement is constructed in accordance with CICA Guidelines from the income statement and the changes in the balance sheet from the beginning of the period to the end. It summarizes sources and uses of funds in the operating, investing, and financing cash flows during the period of time covered by the income statement.

- **Supplemental Data**

  Additional information is sometimes provided that relates to functional costs and other amplifying information useful in analyzing the financial statements and the company’s financial performance.

- **Notes to Financial Statements**

  The notes provide disclosures considered necessary for an informed user, such as a credit analyst, to interpret the financial statements correctly. Reading the notes is an important part of financial analysis. The notes present three kinds of disclosures:

  1. Additional detail about certain accounts and transactions that can help analysts determine creditworthiness.
     
     **Example:** Notes often disclose a schedule of fixed assets, such as land, buildings, and equipment, while the balance sheet may show only a total for gross and net fixed assets.

  2. Information necessary to evaluate the reliability and comparability of the financial statements for the purpose of credit analysis.
     
     **Example:** Notes disclose whether the statements are consolidated with those of other companies or whether they report on the results of only one corporation without its subsidiaries or parent.

  3. Information about certain events or conditions not reported on in the financial statements.
     
     **Example:** Notes disclose contingent liabilities such as purchase commitments, guaranties, and pending lawsuits. They also disclose the company’s financial exposure to market risk.

  The following notes are generally always required. Many companies will need to provide additional disclosures.

  - Nature of operations—description of the major products or services the entity sells and its principal markets, including the location of those markets, plus descriptions of major business lines within the company.

  - Reporting entity—what company or companies are reported on in the statements? Are the statements 1) consolidated, 2) consolidating, or 3) separate or parent only?

  - Accounting policies—critical policies such as basis for stating inventories and the method of determining cost; description of methods used to compute depreciation; policy for treating a short-term investment as a cash equivalent; method used to estimate allowances for doubtful accounts.

  - Other accounting methods selected when alternatives are permissible under GAAP.

  - Contingent liabilities such as guaranties, warranties, purchase commitments, or litigation.

  - Details about liabilities for money borrowed, including requirements such as collateral.

  - Amounts due annually for leases, both operating and capitalized.
It is important to determine the potential financial effect of commitments and contingencies reported in the footnotes, i.e. obligations of your customer that are uncertain as to amount or timing, or that are not yet direct obligations of the company.

useful in analyzing the financial statements and the company’s

**MANAGEMENT LETTER**

This document reports on material operational issues found deficient within your customer’s financial control systems that could represent considerable risk to your financial institution. You should request a copy of the Management Letter and the company’s response to it in order to ascertain the magnitude of the risk posed by the deficiency (ies) noted.

**GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)**

GAAP is a body of specific rules and broad concepts that govern how businesses and their CAs, CMAs, CGAs or CPAs recognize, measure, record, display, and disclose information about a company’s financial transactions. A key phrase in the Auditor’s Opinion states that financials were prepared “on a basis consistent with that of prior years”. This means that you can expect that financial statements prepared by the same CA, CMA, CGA or CPA in accordance with GAAP are comparable from one period to the next in terms of consistency of presentation.

Understanding major GAAP policies and procedures is necessary to determine the usefulness of financial statements in your analytical process. Not all financial statements are prepared in accordance with GAAP; those that are not, require a different interpretation to be useful in the lending decision process.

**CONSOLIDATED AND CONSOLIDATING FINANCIAL STATEMENTS**

All Audited financial statements are prepared on a “consolidated” basis, but it may be helpful for you to request a “consolidating” financial statement when the company has more than one operating subsidiary. Some financial statements report on one single entity, while others combine reporting for several companies, usually in a parent and subsidiary relationship.

If you are lending to a subsidiary and the parent will not be a party to the loan, you need to analyze the separate statements of the subsidiary, not just the statement of the parent or the statement of the parent combined with the subsidiary.

If you are lending to the parent without the guarantee of the subsidiaries, you will need the separate statements of that parent.

Depending on the company or companies reported on, financial statements can be described as consolidated, consolidating, and unconsolidated or separate which reflects the parent (or the subsidiary) only.
<table>
<thead>
<tr>
<th>Type</th>
<th>Features</th>
<th>Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated</td>
<td>Presents the condition and performance of two or more companies combined. Inter-company transactions and account balances are eliminated and do not appear in the financial statements. It is common for financial statements to be called consolidated even when they report on just one entity. The first footnote to the financial statement will identify whether multiple entities are included in the report and their relationship.</td>
<td>Users see how two or more companies present themselves.</td>
</tr>
<tr>
<td>Consolidating</td>
<td>This form of statement displays the financial statements of two or more related companies, shows the inter-company accounts and transactions, then eliminates them and presents the condition and performance of the combined entities.</td>
<td>Users see each company separately, all inter-company transactions, and how they are eliminated to produce a statement. The most informative type of financial statement but expensive to prepare.</td>
</tr>
<tr>
<td>Separate, Unconsolidated or Parent (or Subsidiary) Only</td>
<td>Reflects the condition and performance of only one company not combined with any other company.</td>
<td>Users see how that one company presents itself alone.</td>
</tr>
</tbody>
</table>

- Most financial statement packages provide only consolidated financial statements. Smaller companies that have only a few subsidiaries will normally list them. In larger companies, the footnotes say that significant accounts and transactions between subsidiaries have been eliminated. In either case, the existence of multiple entities almost always suggests the need to request consolidating financial statements or, at a minimum, financial statements for each legal entity at the same date. When structuring a loan you need to consider:
  - What entity (or entities) is borrowing, what entity (or entities) is using the proceeds, and what entity (or entities) is furnishing the collateral. You need to understand these points to ensure that you structure the loan in such a manner that you have access to the cash flow required to repay your debt as well as the security pledged as a second way out if the cash flow does not materialize. Legal issues, may weaken the bank's ability to enforce access to corporate guarantees or collateral if subsidiaries providing either do not receive demonstrable benefit for doing so. These legal issues are complex and require the assistance of counsel.
  - When analyzing repayment ability, it is vital to understand individual operating performance and business risks of the consolidated entities. For example, a consolidated financial report may mask a chronic under-performing subsidiary that consumes disproportionate financial and management resources. Or, a consolidated statement may include subsidiaries whose year-ends are different, introducing the possibility that a significant business unit's financial results are measured at a high point, instead of the more desirable low point, in the operating
cycle. A consolidated financial statement can also hide the diversion of cash from one business unit to another.

- It can be appropriate to focus on a single borrowing entity instead of on some, or all, of the consolidated group. For example, if a manufacturing entity and a service entity are consolidated, for one of them, there will be little or no inventory and cost of goods sold. Inventory turns, payable turns, and gross profit margin may be greatly distorted or meaningless in the consolidated statements.

- Some members of the consolidated group may have earnings or assets that are legally or pragmatically difficult for the borrower to access. For example, earnings and assets from a foreign subsidiary may present tax or legal repatriation impediments, and a lender’s practical access to assets abroad may be very limited in bankruptcy. In this case, stand-alone analysis of the domestic borrowing entity is important.

- If lending to a holding company that relies on cash flow from subsidiaries to service interest or repay its debt, you need to understand if there is any type of agreement at the subsidiary level that would preclude it from funding the holding company. For example, if there is outside debt at the subsidiary level, which has security over assets and cash flow of that subsidiary, the debt at the holding company will be considered to be structurally subordinated. The subsidiary debt will be serviced first and the loan documentation of the subsidiary will most likely preclude distributions to the holding company under certain conditions.

**KEY GAAP CONCEPTS**

Lenders generally prefer GAAP financial statements because:

- Transactions will be measured by historical cost.
- Revenues are recognized when earned.
- Expenses are matched with the revenues they produce.

There are several areas of GAAP that warrant your attention when underwriting a customer relationship.

- Historical Cost
- Revenue Recognition and the Matching Principle
- Expense Recognition
- Conservatism
- Consistency and Comparability
- Materiality
- Limitations of GAAP
**Historical Cost**

Assets will be reflected on the balance sheet at the original cost the company incurred to acquire the asset, plus the cost of any capitalized additions or improvements less accumulated depreciation since the date of acquisition and improvements.

What the current value of the assets is (market value) might very well be considerably different from the original cost and current depreciated cost. Current market value is not reflected on the balance sheet for most accounts. However, you may want to consider the market value of the assets as you look for a second or third way for a loan to be repaid. You must also keep in mind that some current accounts, such as marketable securities, require accounting for the lower of cost or market and are not at historical cost.

**Revenue Recognition and the Matching Principle**

These two principles form the basis of accrual accounting;

- Revenues are recognized and recorded when earned. This happens when the goods or services are shipped or delivered, or completed and stored (with title changing) for future shipment to the customer.

- Expenses are matched to the revenues they help generate, regardless of when payment obligations are actually incurred or fulfilled.

The movement of cash may occur before, after, or at the same time the revenue or expense is recognized.

**Expense Recognition**

Expenses are recognized and recorded when an asset has been used or service received, in the generation of a specific revenue stream.

Sometimes the costs are capitalized (carried on the balance sheet as an asset and depreciated). This occurs when costs are expected to provide benefits beyond the accounting period in which they occurred. The most common method of expensing the cost of acquiring fixed assets revenue is to depreciate or amortize it over the number of years that the asset is expected to provide service. Two depreciation and amortization methods are:

- Straight-line: generally used for financial statement disclosure
- Accelerated: generally employed for income tax reasons

The decision to expense or capitalize depends on management’s desire to report favorable earnings to owners and creditors, and lower earnings for income tax purposes.

The principles of historical cost and accrual accounting and the fundamental standards of conservatism, consistency, comparability, and materiality are cornerstones to Understanding the Numbers and using them in an effective way to assess credit capacity risk.

No body of rules can anticipate and prescribe for every circumstance. When a specific accounting treatment is not prescribed in GAAP, you should be able to expect preparers of GAAP financial statements to rely on three broad standards: conservatism, consistency and comparability, and materiality.
Conservatism

- Assets and revenues will not be overstated.
  
  **Example:** Sales and accounts receivable will be recorded only when the right to receive payment requires no further performance.

- Liabilities and expenses will not be understated.
  
  **Example:** The full amount of income taxes accrued on income generated for the period will be shown, although payment of all or some portion of the taxes may be deferred to a future period.

  **Example:** Wages owed to employees for work performed up to the financial statement date are expensed to the income statement for the period. Amounts not actually paid at the time of the financial statement are shown on the balance sheet as a liability: accrued wages.

Consistency and Comparability

Comparability of financial statements is important in order to compare financial statements among companies in the same industry. The concept of consistency and comparability means:

- The results of transactions will be measured and recorded in the same way from one period to the next for similar kinds of companies.

- Changes and permissible variations will be explained in sufficient detail so that the analyst can render the statements comparable.

  **Example:** Footnote disclosure must include the method of accounting for inventory and whether the company has changed methods since the prior year’s statement.

Materiality

Statement preparers will classify and disclose the results of transactions in a way that acknowledges their significance to the company’s financial condition.

**Example:** A purchase of paper clips by a small publishing company will be expensed entirely when the purchase is made, even if some of the paper clips will still be around in the next reporting period. However, advance payments to an author might be capitalized and then expensed when the book is complete and being marketed.

**Example:** Footnotes must disclose contingent liabilities such as pending lawsuits. The magnitude of the lawsuit determines whether it needs to be disclosed and if so the degree of detail that is required. For example, a $200 lawsuit would in most instances not require disclosure as it would not have a material affect on the company.

Limitations of GAAP

The principles of historical cost and accrual accounting and the fundamental standards of conservatism, consistency, comparability, and materiality are not always entirely beneficial in credit analysis.
GAAP financial statements have the following limitations. Your analysis must take these limitations into account.

- The use of historical cost can cloud an analyst’s ability to recognize current values. In some cases, you will need to obtain appraisals of significant assets and liabilities.

  Example: A company might have bought land many years ago at a low cost. The current market value of the land could be much higher than the cost reflected on the balance sheet.

  Example: A company might owe long-term creditors $2 million reflected on the balance sheet as the face amount of principal payments due. If the notes bear a below-market rate of interest, the creditors could be willing to accept less than $2 million if they could be paid in full immediately.

- The matching principal can obscure the receipt and payment of cash. You should identify actual cash inflows and outflows.

  Example: A company has a capitalized lease recorded as both an asset and a liability on its balance sheet. The accrual basis income statement will reflect a non-cash charge for amortization, but the actual cash payments on the lease may not be the same as the amortization expense.

- GAAP permits alternatives to account for some kinds of transactions. The use of different alternatives makes it difficult for analysts to compare financial statements and increases the importance of footnote disclosure.

  Example: Companies are permitted to use either straight-line or accelerated depreciation for financial reporting.

- GAAP permits certain industries to use accounting methods that are not consistent with similar transactions in other industries. You need to learn the specific accounting methods used in a particular industry in order to effectively analyze financial statements of these companies.

  Example: Companies that develop software for sale may capitalize the costs and match them to the revenues they produce. Companies that develop software for their own use must expense the costs when they are incurred.

**UNDERSTANDING THE MARKET VALUE OF THE CUSTOMER’S ASSETS**

Despite the benefits of GAAP financial statements, you need to be concerned with the current and future market value of many of the company’s assets. The following questions relate to understanding the market value of your customer’s assets:

- What is the collateral value of the asset(s) securing your loan, assuming a willing buyer and normal market conditions?

- What is the value of the asset when disposal is required quickly in less than optimal market conditions?

- How does the market value of assets affect the “real” net worth of the company?

The reliability of asset valuation stems from the independence and market knowledge of the individual preparing the valuation. A note of caution here; sometimes valuations are based
upon a very small and illiquid market place and at other times there exists a large well-established market place that lessens the risk of “protecting the loan” or relying on the sale of assets as “second way out.”

Liquidation values (the only real measure of collateral value) are difficult to establish and maintain over the life of an asset, because of changes in the demand for the asset. The liquidation value is dependent on the condition of the asset and general economic conditions at the time of sale.

The source of the valuation is often critical to the confidence placed on the value established. The same analysis should be completed on an appraiser of an asset as you would with regard to an Auditor doing an audit. Any appraisal of an asset must itself be evaluated for reliability and accuracy, even to the point, in some cases, of obtaining multiple appraisals on the same asset.

The following asset categories need to be considered in the asset valuation analysis:

**WORKING CAPITAL ASSETS**

*Inventory Valuation Methods*

- **FIFO (First In, First Out):** Under FIFO: the assumption is made that the inventory that was purchased first has been sold and the items purchased most recently are still on hand in inventory.

- **LIFO (Last In, First Out):** Under LIFO, the assumption is made that the inventory that was purchased first is still on hand, and the inventory purchased more recently has been sold. In the United States there is the concept of a LIFO reserve which arises when a company uses the LIFO method of inventory valuation while inventory prices are rising. A company that has a LIFO reserve has a lower inventory balance, a higher cumulative COGS (Cost of Goods Sold), and a lower cumulative pretax profit than it would have if it used FIFO over the same years. The LIFO reserve is a dollar amount, disclosed in the Notes To Financial Statements. In Canada, because FIFO is the method of accounting required for income tax purposes, most companies also use that for accounting purposes. If there is a question with respect to the differences, refer to the Notes to the Financial Statements to determine which method is utilized. If LIFO is used for accounting purposes, the tax returns will show the financial results assuming FIFO had been used.

- **LCM (Lower of Cost or Market),** in which case the raw materials in inventory are valued at the lesser of the purchase price, or what the current purchase price is. Any write-down in the valuation of inventory is included as an expense under COGS.

- **Specific identification** values the inventory based on the ability to specifically identify the asset. It is generally utilized in instances where inventory is of high value (as in jewelry) or serial numbered (as in automobiles).

- **Weighted average cost** is utilized when several batches of unidentifiable product are purchased throughout the year. For example, if twelve orders of identical candles are brought into inventory in a year, the amount expensed to COGS would be the average price, and the inventory remaining would reflect the average price of the unsold items.
**Marketable Securities**

These assets are stated at the lower of cost or market (mark-to-market) and are generally valued based upon posted prices on recognized security exchanges.

**Fixed Assets**

Unless these assets are specialized in nature, they can be valued by certified appraisers based upon readily available and comparable market data. Examples include:

- Furniture, fixtures, and equipment (FF&E)
- Buildings and land

These are also sometimes referred to as Property, Plant and Equipment (PP & E).
LONG-TERM ASSETS

These assets are much harder to value because of the volatility in the market place for the following types of long-term assets:

- Investments
- Investment in subsidiaries
- Intangibles

The valuation of operating subsidiaries and intangibles, such as intellectual property rights and patents, can be very complex requiring highly sophisticated appraisals.

LIABILITIES

Liabilities are carried at face value, but consider the following issues:

- Adequacy of reserves: accrued liabilities sufficient to completely extinguish the company’s commitments
- Tax liability: tax payable and tax deferred accounts

COMPANY-PREPARED FINANCIAL REPORTS

These reports (usually limited to a balance sheet and income statement) are used extensively in the interim analysis of a company’s operation. They are generally submitted in compliance with loan covenants or other agreements between you and your customer.

Even though these statements are not independently prepared in accordance with GAAP, if prepared consistently with the Auditor’s reports, they can be useful in assessing risk or monitoring financial performance in the time period between audits. Company prepared financial statements, along with an officer’s certification (attesting to their accuracy), are often used to measure compliance with loan covenants. Negative variances to covenants can trigger defaults. Positive variances can trigger interest rate reductions or the relaxation of covenants. Publicly traded companies must file quarterly financial statements with the appropriate regulatory agency and these can be useful in determining interim results. In the United States publicly traded companies must file 10Qs with the SEC (Securities and Exchange Commission), and in Canada the companies must file information with the regulatory authority which governs the listing of their securities as well as any Jurisdiction where any prospectus was issued. For instance, those companies that trade in Ontario must file information with the Ontario Securities Commission as well as the Business Corporations Act of Ontario.

The lender who relies exclusively on company-prepared financial statements may be subjecting the institution to undue risk.

CASH-BASIS AND OTHER FINANCIAL STATEMENT PREPARATION METHODS

Many smaller companies provide cash-basis financial statements, or use another basis of accounting which may be called “modified cash basis” or “tax basis” accounting. These companies will typically also provide tax returns, so our concern is less one of verifiability than of the pitfalls of analysis when we cannot evaluate accrual-basis financial statements.
Cash Basis

This basis of accounting measures and records dollar impact of transactions when they are paid for, and not necessarily when they happen.

- Revenues are recorded only when cash is collected.
- Expenses are recorded only when cash is paid to settle them.

Income is simply what is left after cash outlays for a period are subtracted from cash receipts for the same period.

The most significant issue when analyzing cash basis financial statements is they do not accurately measure profit unless the business is very simplistic. Cash-basis statements:

- Understate revenues if the company sells on credit.
- Understate expenses if the company buys on credit.
- Distort expenses if the company uses long-lived assets such as trucks.

For example, does a truck get “used up” in the year of purchase? Shouldn’t some of the truck expense be “charged” to later years, when the truck is still being used in the business?

Modified Cash Basis

This basis of accounting starts with the cash basis, but attempts to overcome some of the profit measurement distortions inherent in that method. There is no specific set of “rules” for modified cash basis accounting. Modifications have evolved through common usage in practice.

Most companies that provide lenders with financial statements labeled as “cash” are in reality submitting modified cash basis statements. A true cash-basis balance sheet would show cash and equity as its only accounts; for example, purchases of equipment and inventory would be reflected only as reductions in the cash account.

Common modifications to cash transactions include:

- Divide the cost of property, plant, and equipment over the years they will be in service.
- Show the property, plant, and equipment as assets on the balance sheet.
- Record each year’s portion of the cost as depreciation expense.
- Recognize borrowed funds as liabilities on the balance sheet. Some companies show accounts payable; most companies show bank loans.
- Recognize income taxes to be paid after year-end as a current obligation.

Tax Basis

This approach to accounting measures and records the dollar impact of transactions according to allowable income and expense recognition under tax laws. The basis of
accounting allowed by tax law can range from accrual to cash. Some tax laws permit special accounting treatments that conform to neither accrual nor cash basis principles.

Tax basis financial statements closely mirror the income and expenses reported on the tax return, regardless of how the underlying transactions might be measured under either accrual or cash accounting. Examples where tax laws allow transactions to be measured differently than under accrual or cash accounting include:

- **Using an accelerated depreciation method**

  Tax rules allow fixed assets to be “written” off faster in early years of use than accrual accounting rules permit. Using the tax rule to report depreciation on the financial statement can result in material differences between true accrual profit and what is reported.

- **Recognizing sales revenue on an installment basis**

  Tax rules allow delaying recognizing the revenue from some sales if payments for the sale will take place over time. Accrual rules do not generally allow installment sales accounting, because revenue recognition is not based on cash collection. Following the tax rules when reporting such revenue on the income statement can result in a significant difference between true accrual profit and what is reported.

- **Expensing a vehicle lease payment when under accrual accounting rules, it would not qualify as an operating lease.**

  Tax rules can sometimes permit the full payment on a lease to be deductible even when under accounting rules, only depreciation and interest expense may be considered as expense, if the lease qualifies as a tax lease but not an operating lease. Following tax rules, and thus reporting lease expense instead of interest and depreciation expense, can result in a material difference between true accrual profit and what is reported.

There is no comprehensive set of guidelines for “tax basis accounting.” It is very difficult to assess the true profitability and financial condition of a company from a tax-basis financial statement without detailed explanations of where the financial statement departs from accrual accounting, and the dollar implication of those differences.
Balance Sheet Quality Analysis

Assessing the quality of the balance sheet accounts is essential to assessing your customer’s ability to repay.

Management’s utilization of assets is the income and cash flow generator for a company and therefore is key to understanding the repayment capacity of the company. Assets should be analyzed critically and their values constantly challenged in light of changing market conditions. How these assets get funded (source, term, and cost) is extremely important to the company and your financial institution and therefore present additional and different risks that need to be understood. The following will be reviewed in this section on balance sheet analysis.

- Classification of Asset Accounts
- Classification of Liability Accounts
- Classification of Net Worth (Owners Equity) Accounts
- Balance Sheet Ratio Analysis

Quality of Asset Accounts

The balance sheet items generally begin with cash, the most liquid asset, and descend to the least liquid, long-term or non-current assets. This arrangement is useful because the liquid assets are the most readily available to repay loans. You should pay specific attention to those assets used in operations of the business: i.e. operating assets.

In your analysis, determine the liquidity and quality of the asset. To determine asset quality:

- Verify what the asset accounts actually represent and decide whether classifications of current and non-current are sufficiently conservative.

- Evaluate characteristics that affect the asset’s convertibility to cash and resulting ability to repay debt. Factors to consider are:
  - Restrictions on the use of the asset
  - Net realizable value of the asset in the normal course of business or in partial or complete liquidation of the company
  - Company’s ability to operate without the asset
  - Time required to convert the asset to cash

Current Assets

Current assets are usually liquidated or used within the company’s operation within a year. There may be a business cycle that sets requirements as to the amounts of cash, accounts receivable and inventory at different times of the year.
**Cash and Cash Equivalents**

Cash is the common denominator (regardless of the currency used) for all business transactions. Cash is not without risk! Cash on hand and cash in banks are the basic forms of cash. However, cash may be restricted by some form of agreement and not available to use in the business, or to repay debt. When lending to domestic companies, there should be no currency valuation risk to cash. Generally, the risks involved with cash revolve around the solvency of the financial institution holding the cash and transactional risk involved in accessing or moving those funds.

Cash Equivalents (often called marketable securities) are financial instruments used by management to increase the investment return on cash. These investment vehicles may include Certificates of Deposit or Guaranteed Investment Certificates (generally less than one year in duration), treasury notes, commercial paper, etc. The risks in this category are associated with:

- Solvency risk of the issuing institution. Is the safety of the investment (principal and interest) assured?
- Transaction risk of accessing or moving the funds. Can the company get at the funds in the normal course of business?
- Valuation risk that translates into the liquidity risk associated with the credit standing of the issuing institution and the opportunity cost created by the term of the instrument and the movement of interest rates since the investment originated.

**Accounts Receivable (A/R)**

A/R represent funds due the company by the purchasers of your customer’s goods or services. The quality and liquidity of this account is a key determinant of the company’s profitability and cash flow and consequently its ability to repay debt.

Discussing this one account is the fastest way to understand the nature of the company’s business. Some of the risks involved with accounts receivable are as follows:

**Credit Policies and Terms of Sale**

- When, where, and how is your customer going to be paid for the sale of goods or services?
- Are there any unusual terms (such as datings) that are typical for the industry?
- Does your customer sell under a purchase order or contract under which partial shipments (sales) are made?
- How large is the average sale?

**Composition**

- Are there any concentrations of sales:
  - To customers
  - By product line
By geographic area
By socioeconomic market

**Valuation**

What is the face value of each account receivable less any discounts for quick payments, returns and allowances, and amounts deleted as a result of “amount owed” disputes?

**Collateral Value**

Cash flow generated from A/R turn in the normal course of operations maximizes the value of the accounts receivable. The liquidation of A/R other than in the ordinary course of business will often dilute their value as well as increase the cost of collection. A 75% - 80% advance rate on the value of A/R is typically used for collateral purposes, but the margin advance rate may be lower depending upon the quality of the receivables and such things as concentrations, agings, and other factors relative to the A/R account.

**Agings**

An A/R “aging list” will provide the following information:

- Names of customers
- Amount owed
- Age of the receivable from date of sale. In some instances, based on your financial institution's policy, the aging may start from the date the funds are due, rather than from the date of sale if the vendor provides a time frame after the date of sale before the invoice is actually “due”.
- A/R that are delinquent and ones which may become problem accounts
- When considering the collateral value of A/R for a loan, for a specific A/R you must decide whether to eliminate only the amount due beyond an acceptable date (perhaps 90 days) or eliminate the entire account if any amount is due beyond that acceptable date (whole account basis). A/R turnover is a key parameter (swing factor) in analyzing a company’s cash flow

**Collection and Charge-off Policy**

Is the “policy” in writing, applied consistently, yet flexible enough to support temporary changes in payment patterns?

**Dilution or Contra Accounts**

Could there be a reduction in the A/R by the amount of a liability (account payable) that your customer owes to that same company? When compared to your customer’s accounts payable aging, determine if they can offset the A/R with the amount of the liability owed.

Inter-company receivables should also be deducted from total accounts receivable unless there is a compelling reason not to exclude them.
Stock Inventory

Composition

- Raw material
  - How much raw material inventory is necessary to keep on hand? Some considerations are:
    - Sufficient amount of raw materials to support the company’s production cycle: Is the customer’s production process geared to “just in time” delivery for its raw material components, or are they pulling from inventory that has been stockpiled on some EOQ (economic order quantity) schedule?
    - Spoilage and damaged goods factor: Is there a recurring tendency for raw material inventory to spoil or get damaged? This can lead to production flow disruptions and write-downs of inventory.
    - Obsolescence and style changes: This is especially important to companies in industries where there are significant and quick technological or style changes (i.e. clothing, food, automobiles, housing, etc.).

- Work in process (WIP)
  WIP is the component of inventory that is in various stages of completion. It must be completed prior to a sale or transfer to finish goods inventory. Is it being produced for finished goods inventory or is it being produced for a specific order or open purchase contract?

- Finished goods
  This category of inventory often has the most value to your institution as collateral in the event of payment default and liquidation. You want to know how long before it is to be shipped under a sales order. This category is also subject to the risks of obsolescence, style changes and spoilage.

Valuation

How is the inventory valued? Inventory is generally valued under one of the following methods (which were defined previously in this Dimension):

- FIFO (First In, First Out)
- LIFO (Last In, Last Out)
- LCM (Lower of Cost or Market)
- Specific identification
- Weighted average cost

Collateral Value

Cash flow generated from inventory turn in the normal course of operations maximizes its value. The sale of inventory in any other manner than in the ordinary course of business will
often dilute its value as well as increase the cost of getting the inventory to the point of sale. A 40% value of inventory, or the ‘margin’ applied to inventory is typically used for collateral purposes, but that percentage may be high depending upon the proportion of finished goods to total inventory and ultimate value in liquidation. As a general principal, WIP is margined at a lower value than finished goods and often times is not allocated any value for margining purposes. The margin on raw materials will be affected by the composition of that inventory. If it is comprised of freely traded commodities with alternate uses (such as steel) it will likely have a higher margin than single purpose units with limited alternate use (such as a custom part manufactured specifically for use in the end product).

- **Write Down Policy**
  - Is the policy for writing down unsaleable inventory documented, applied consistently, and flexible enough to handle sudden changes in customer purchase patterns? Is it endorsed by the company’s auditor?

- **Insurance**
  - Is the inventory insured at market value? Does the company maintain business interruption insurance to ensure that sufficient cash flow is available to fund the operations of the business, including making debt payments, in the event of a catastrophe?

- **Inventory Turn**
  - How fast is the company converting inventory to cash? A ratio analysis measuring inventory turn is especially important in the lender’s assessment of risk.

- **Suppliers and the Company’s Delivery Infrastructure**
  - Are all major suppliers analyzed for financial stability and ability to deliver quality products within established time parameters?
  - Are there any risks imposed by the delivery mechanism, such as the transportation company’s financial stability, potential for labor disruptions, or weather related delays?

**Other Current Assets**

This category includes prepaid assets, loans to officers, and any other assets expected to be used within the business or converted to cash within a year. Generally, other current assets are:

- Not very liquid
- Often considered long-term for purposes of a financial analysis, so as not to impact working capital asset analysis
- Eliminated from net worth analysis to assist you in arriving at a “tangible net worth” number
- Generally negligible in amount. A significant amount signals a need for further investigation
**Fixed Assets**

Fixed assets are sometimes referred to as operating assets and typically include property, plant, and equipment (PP&E). The real value of fixed assets (as opposed to insurable value or liquidation/collateral value) is in their contribution to the production and sales cycle. Fixed assets may be owned directly or leased, or the function can be outsourced. If they are purchased, the costs of acquiring and carrying (depreciation) these assets occur over a period of greater than one year, hence their long-term categorization.

In the buy, lease, or outsource decision, is it better to:

- Own the fixed assets with all of the inherent responsibilities and risks of ownership?
- Obtain utilization of the asset through renting or leasing?
- Outsource some or part of the manufacturing process?

It is not always an objective modeling analysis that leads management to the final decision of how to acquire the utilization of the fixed asset.

If the fixed assets are purchased, then the following points should be analyzed:

- What is the present condition, annual cost of maintenance, and expected remaining life of the asset?
- Is the asset subject to rapid technological obsolescence? This issue is present when acquiring highly specialized equipment, which might lead to a faster write-off of the asset than originally expected.
- Is the asset purchase a proper utilization of the company’s capital?
- What is the value of the asset in the event of liquidation? Sometimes secured lenders take PP&E as a secondary source of repayment of a loan without extensive analysis or valuation.

If utilization of the asset(s) is obtained by leasing or renting, the company remains in control of the asset and therefore the manufacturing process. Relevant costs include annual lease payments and maintenance, operator and facility expenses.

If all or a portion of the manufacturing process is outsourced, the company is subjecting itself to a number of risks which need to be analyzed.

**Investments and Other Long-Term Assets**

What are these assets and why are they there? Analyze their purpose within the strategic plan of the company.

- Are these investments intended to diversify the company’s cash flow streams?
- Are these investments in a “holding” category until they can be put into service within the operation of the company: for example, land held for future expansion?

Analyzing the nature and quality of these assets can reveal a great deal about peripheral activities in which the company is involved.
The key questions are:

- How much risk do these assets introduce to the company’s balance sheet?
- How much secondary collateral does this category of assets provide?

Cash surrender value of life insurance (CSVLI) on your customer’s key officers often falls into this category. This asset (especially the face value of the policy(s)) can be valuable to you to support the cost of replacing a deceased key officer and provide management continuity to the business. Only the CSVLI should be listed on the balance sheet, not the face amount of the insurance policy.

Any assets in this category reclassified from the current asset section of the balance sheet such as “due froms” and “deferred receivables” are suspect in terms of quality or liquidity.

**Investment in Affiliates**

What is the real value of separate operating entities that are not wholly owned by the company? Assets in this category may have a critical impact on the company’s income and resulting cash flow. If these assets are significant in magnitude or represent a large percentage of total assets, they should be analyzed as thoroughly as a stand-alone company. The affiliate’s assets, liabilities, and net worth need to be analyzed with respect to their cash impact (flow and risk) on the company that you are funding.

**Intangibles**

What is the contribution of these assets to the overall market value of the company?

Assets in this category are generally not liquid in the ordinary course of business but may be important to the company strategy. For example, intellectual property assets may differentiate the company in the market place. Goodwill may be a tax driven account created after an acquisition or it may have real value in terms of “branding” the company’s products in the marketplace. An intangible asset’s value and liquidity, either together with, or separate from, the operating assets of the company, may be the most crucial analysis that you can make.

Establishing the nature of the intangible asset and its purpose in the company’s operation will dictate the extent of the analysis required and degree of comfort the asset provides as collateral. As a general principle, the value of intangibles reduces significantly, or completely disappears, in a liquidation scenario.

**Other Long-Term Assets**

What other assets are owned by the company but do not fall into any other account?

Other Long-Term Assets are generally not material in the financial presentation or particularly important to the ongoing operations of the business. Analyze when significant in amount or trend.

**Classification of Liability Accounts**

Beginning with current liabilities, the balance sheet lists the liabilities by timing of payments due. There is also some correlation between where liabilities are listed and their cost to a company, beginning with accounts payable with no cost if paid within terms.
As you examine your customer’s liabilities, think about what the profile of those liabilities tells you of existing creditors’ judgments about the company’s creditworthiness. Existing liabilities, including those from your institution, will compete for cash available for debt service. In reviewing your customer’s liability structure, look for the following:

- Source and stability of existing liabilities
- Cost to the company
- Terms and conditions by which the company must abide
- Priority in which obligations must be paid
- Current Liabilities
- Non-current Liabilities

**CURRENT LIABILITIES**

These accounts, all due within one year of the financial statement date, may be payable on demand, within specified invoice terms, or other scheduled basis. The greater the amount of current liabilities, the greater the need for cash to satisfy those obligations as they come due.

**Overdraft Facilities or Demand Loans**

Current liabilities will include any amounts outstanding on authorized Overdraft Facilities or Demand Loans. As a result of recent changes to GAAP, the entire amount of a demand loan is now regarded as a Current Liability.

**Accounts Payable (A/P)**

The support of suppliers (the “trade”) is critical to funding a company’s operation. Trade support is often more important than the support of an individual financial institution. This is especially true if your customer purchases goods under an exclusive franchise or distributorship agreement where the company cannot acquire the product from any other source.

A/P represent funds due to various vendors for products and services that they have supplied or performed. The same approach used with A/R should be employed when analyzing A/P.

- Terms of Payment
  - When, where, and how is your customer to pay for the goods or services received?
  - Are there any unusual terms (such as datings) that would alter the normal outflow of funds?
  - Do they purchase under a purchase order or is there a contract under which they have received partial shipments?
  - How large is the average purchase?

- Composition
Are there any concentrations of suppliers either due to availability of the product or service, or contractual arrangement?

- Valuation
  - A/P are listed at face value less discounts for timely payment, returns and allowances, and amounts deleted as a result of “amount owed” disputes.

- Aging
  - An A/P aging list will provide the:
    - Names of suppliers
    - Amount owing
    - Age of the payable from invoice date
    - Delinquent A/P (extending beyond terms of payment) and ones which may become payment problems
    - A/P turnover is a key parameter (swing factor) in analyzing a company’s cash flow

- Collection Accounts
  - Are any A/P in collection, and, if so, why? Are these accounts major suppliers to the ongoing operation of the company?

- Dilution or Contra Accounts
  - In the event of an A/R collection problem with a customer who is also a supplier, is there an opportunity to offset the amount owed the supplier by the amount of the A/R?

- Suppliers and the Company’s Delivery Infrastructure
  - Are all major suppliers analyzed for financial stability and ability to deliver quality products within the prescribed time?
  - Are there any risks imposed by the delivery mechanism, such as the transportation company’s financial stability, potential for labor disruptions, or weather related delays?

**Notes Payable (N/P)**

Who holds the short-term debt if your institution does not? What are the terms and conditions?

It is especially important to know who is advancing funds and vying for the company’s cash flow dollars. Anticipate how the bank might have to interact with other debt holders in the event of a problem.
Overdrafts (other than Authorized Overdrafts as noted above)

Why does your customer show overdrafts?

The existence of overdrafts indicates either:

- Astute cash management techniques being employed by the company (overdrawn on the company’s books but not at the financial institution).
- A severe problem with cash flow and liquidity.

This account inevitably leads to a discussion with your customer’s management about the minimum level of cash necessary to support day to day operations.

Accruals or Accrued Expenses

What is the nature of the company’s accruals?

These are accounts payable for items routinely expensed through the income statement (salaries, bonuses, vacation and holiday pay, and interest), but not as yet paid. This category should be a relatively small amount relative to other liability categories; if not, investigate.

Unearned Revenues

Why is the company showing unearned revenues? What is your customer's revenue recognition policy?

This category includes the liability for cash received by the company, but for which a service has not been performed. For example, an educational institution’s tuition payment that is received in August has not been earned as of that date. Depending upon the contractual commitment between your customer and entity that paid the funds, these monies may need to be returned due to a lack of performance. This is usually an accounting category that fluctuates with the company’s natural business cycle and traditional income flows for that industry.

Current Portion of Long-Term Debt (CPLTD)

What are your customer’s scheduled current payments on their long-term debt? Under GAAP the entire balance of demand loans require treatment as CPLTD, but you need to understand the amount that will actually be paid over the next year based on the repayment schedule.

What would give reason for those payments to be accelerated? CPLTD is the first call on net cash income on the Direct Cash Flow Statement. See also the risks of long-term debt (Non-current Liabilities) discussed below.

Due to Officer/Stockholder

Why is an officer or principal providing funds to the company?

This category often occurs in small and mid-sized privately held companies in which the principal officers and/or stockholders inject funds into the business. You should determine the purpose of the debt and when it is to be repaid. This type of debt should be documented, although often it is not.
If you are looking for more capital support for your institution’s debt, with proper documentation, generally a guarantee and/or postponement of claim, this type of debt can be subordinated to your institution’s interests. Depending on the documented agreement with your client, it can be considered equity for our purposes.

**Advances or Deposits**

In some industries (i.e. construction, capital equipment, etc.) this category is a significant and consistent source of funding.

Each account should be analyzed for the following:

- How did the advances/deposits originate?
- How do these funds become earned?
- Under what conditions would they have to be returned to the funding source?

**Non-current Liabilities**

What is the nature of all non-current liabilities and under what circumstances could they be accelerated?

These are liabilities that, in the ordinary course of business, are not due within one year. However, they often have terms and conditions that, if violated by the company, can accelerate the payment date into the current year with the resulting potential drain on cash flow.

**Long-Term Debt (Including Senior Debt, Subordinated Debt, and Friendly Debt)**

Each note recorded in this account should be analyzed for the following:

- Who is the Debt-Holder?
  
  If your financial institution doesn’t hold all the long-term debt, what entity does?

Especially in workout loans it is important to know who is vying for the company’s cash flow dollars. It is also important to anticipate how your institution might have to interact with other financial institutions or individuals to ensure that all debt holders have fair and equitable access to the cash flow of the business.

- What is the Amount of the Debt?

  What is the outstanding principal balance on the date of the report and the amount unused that may be available as reported in the Notes to Financial Statements? Has any other debt been incurred since the date of the report?

- What are the Terms and Conditions?

  Are there any contractual provisions that could accelerate the debt? Are there any cross default provisions that could otherwise negatively impact the company’s cash flow from what it is expected to be, based upon the long-term debt’s contractual repayment terms?

- What is the Interest Rate?
What is the stated interest rate and any “upset” rates? Under what circumstances would those “upset” rates go into effect?

**Deferred Items**

How did the deferred items come into existence?

These are usually income taxes that have been reported in the financial statements, but not yet incurred because the company has utilized allowed tax deductions such as accelerated depreciation.

**Commitments and Contingencies**

To determine the company’s commitments and contingencies, or contingent liabilities, you must review the Notes to Financial Statements. The following are a few examples of common commitments and contingencies, and some of the issues to consider when reviewing the notes to ensure the ratios calculated accurately reflect the risk of your borrower.

Common commitments and contingencies include:

- **Operating leases**

  Under an operating lease, the company is obligated to make a series of minimum annual rental payments, and may include the option to purchase the leased asset at the end of the lease for its then-fair-market value. The asset does not appear on the balance sheet, and there is no related debt obligation. If the amount of lease payments is significant in relation to the total annual debt payments, you may want to consider including the rental payments as “interest” for the purposes of Debt Service Coverage Ratio (DSCR) and Debt to EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). We discuss these later in the Dimension, but basically “Interest” for each calculation is replaced by “Interest and Rental Payments”. For the DSCR this variation can give you a much better feel for the company’s ability to service both debt and leases. In the Debt to EBITDA calculation, the calculation provides a more realistic picture as operating lease payments in some ways are simply an alternate form of financing.

- **Guaranteed or other Contingent Amounts**

  Parent companies that guarantee debt of subsidiaries are required to disclose the contingent liability in the notes to the financial statements. Guarantees can simply be added to the parent’s debt to test their prospective impact on the parent’s balance sheet.

  Similarly, guaranteed contracts, obligations under deficiency agreements, standby letters of credit or other contingent obligations can be added if you believe performance on these contingencies may be required during the loan term. In order to be conservative, some financial institutions require that these obligations be included in ratio calculations.

- **Non-Guaranteed Debt of Unconsolidated Subsidiaries**

  Although a borrower may not have legal recourse for the debt of its subsidiary or joint venture partner, there may be such strong ties to the sub/partner that it is unwilling to walk away from the relationship. The parent/partner may find it necessary to either cover the debt or make additional investments instead of abandoning the project or sub. When the likelihood of abandonment is very low, adding the non-recourse debt to the parent’s balance sheet helps quantify the financial impact of the relationship.
• Receivables securitized with recourse.

When a borrower securitizes accounts receivable, it means that the receivables are “sold” to a third party that is responsible for their collection. It is common for the borrower to provide some element of credit support or enhancement to the transaction, which protects investors from loss on their securities when there are losses in the underlying asset pool.

The form of enhancement may not be as obvious a simple recourse arrangement, however. For example, the originator may put aside cash in a reserve account to absorb credit losses, or there may be performance contingencies that require additional cash to be provided to the special purpose entity that sells the asset-backed securities. Alternately, the originator may retain risk by retaining a subordinated interest in transaction. The subordinated interest absorbs losses on the underlying asset pool before more senior interests absorb losses. Careful reading of footnote disclosures should reveal any direct or indirect recourse, in which case the adjustment to the balance sheet includes adding back the amount of the receivables and a like amount of debt.

• Pension liabilities

Pension liabilities are off-balance sheet but must be included in the Notes for publicly traded companies. While it is possible to calculate the overall liability, in most instances it is simply important to understand the unfunded liability, and determine what effect that could have on the company going forward.

CLASSIFICATION OF NET WORTH (OWNER’S EQUITY) ACCOUNTS

Net worth or owner’s equity is the mathematical difference between the company’s total assets and total liabilities (Asset = Liabilities + Equity).

Mathematical net worth can differ from tangible net worth. The concept of tangible net worth takes into consideration the volatility in value and liquidity of some non-operating assets. These non-operating assets may include officer debt, intangibles, asset reclassifications, other assets, and investment in affiliates. If the underlying value of these assets is suspect, they should be deducted from total assets before calculating net worth.

\[
\text{Total Assets} - \text{Intangibles/excludables} - \text{Liabilities} = \text{Tangible Net Worth}
\]

Structural components of net worth will vary with the legal forms of the entity and the applicable section of the tax code under which the company is chartered.

The following charts describe the most common tax structures and legal forms of ownership, their features, and the significance of each from the perspective of the equity holder.

• Legal Structure

• Tax Structure

Legal Structure

Most companies operate under one of the following organizational structures:
<table>
<thead>
<tr>
<th>LEGAL FORMS</th>
<th>BALANCE SHEET</th>
<th>FEATURES</th>
<th>SIGNIFICANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROPRIETORSHIP</td>
<td>No capital stock. Balance sheet of borrower includes business and personal assets and liabilities.</td>
<td>One individual, a sole proprietor, goes into business. Individual and business are not separate legal entities. Business may have trade name or be referred to as individual doing business as (dba) [trade name].</td>
<td>Owner has unlimited liability for actions and obligations of business. Management is solely the owner/operator. When owner dies, business does not continue as it is not a separate legal entity.</td>
</tr>
<tr>
<td>GENERAL PARTNERSHIP</td>
<td>Partners’ initial investments, if any, and partnership earnings not yet withdrawn.</td>
<td>Two or more individuals go into business together. Partnership is separate legal entity but in most cases is automatically disbanded on the death of one partner. Partnership agreements, required in many Jurisdictions, specify who can obligate partnership and how profits or losses will be shared. Business may have trade name or be referred to as doing business as (dba) [trade name].</td>
<td>Each partner is fully liable for obligations of partnership, but in some Jurisdictions it may be that the liability of the partnership is second in priority to personal obligations of individual partner.</td>
</tr>
<tr>
<td>LIMITED LIABILITY PARTNERSHIP</td>
<td>Dictated by the Jurisdiction in which they are established.</td>
<td>Same as General Partnership. Requires registration with the appropriate Jurisdiction to obtain LLP status. Business may have trade name or be referred to as doing business as (dba) [trade name].</td>
<td>Same as General Partnership except partners not liable for wrongful conduct if they are not involved. Partners are liable for debts of partnership that existed prior to registration but not new debt incurred since registration. Single taxation applies. Partners are taxed individually on their share of the profits.</td>
</tr>
<tr>
<td><strong>LIMITED PARTNERSHIP</strong></td>
<td>General partner manages the business and limited partners contribute capital but are not usually active in the business. Limited partners are liable for partnership obligations only to the extent of their investment. Business may have trade name or be referred to as doing business as (dba) [trade name].</td>
<td>To have a claim against limited partners for loans to partnership, bankers must take special steps in structuring and documenting the loan, such as obtaining guarantee agreements from limited partners. In certain circumstances, limited partners can be liable for loans to the partnership if they are actively involved in the management of the partnership.</td>
<td></td>
</tr>
<tr>
<td><strong>JOINT VENTURE</strong></td>
<td>Special form of partnership in which investors go into business to do a specific project (venture). When the project is completed, the joint venture is dissolved, and profits or losses are shared. Business may have trade name or be referred to as doing business as (dba) [trade name].</td>
<td>Lending to joint ventures requires both special documentation and analysis that addresses temporary nature of the business. Joint venturers are taxed individually on their share of the profits. To ensure joint venturers are liable for debts you need to take guarantees.</td>
<td></td>
</tr>
<tr>
<td><strong>CORPORATION</strong></td>
<td>Legal entities, chartered under the laws of the appropriate Jurisdiction(s), have unlimited life and are unaffected by changes in ownership. Owners' potential for loss is limited to the amount of their investment and they are not personally liable for obligations of corporation. Business may have trade name or be referred to as doing business as (dba) [trade name].</td>
<td>When bankers want the support of owners for loans to corporations, special documentation such as personal guarantees is necessary. Corporations are double taxed on corporate income and dividends.</td>
<td></td>
</tr>
</tbody>
</table>
BUSINESS TRUST/INCOME TRUST

As per Corporation

Not a legal entity, although the management is generally under a Corporate Trust so is similar to a corporation. Owners’ potential for loss is limited to the amount of their investment and they are not personally liable for obligations of corporation. Business may have trade name or be referred to as doing business as (dba) [trade name].

When bankers want the support of owners for loans to corporations, special documentation such as personal guarantees is necessary. Unitholders are responsible for taxes.

ACCOUNT CATEGORIES

The general categories of accounts that comprise owner’s equity are described below. In large and highly complex companies there can be many subdivisions within each category. If there is a category with which you are not familiar, you should speak with your institution’s Auditor or your customer’s Auditor.

- Capital Stock

  The balances of these accounts (in the case of multiple and/or different kinds of stock issues—common or preferred) represent the par value (in many cases $1/share) of the company’s stock issues.

- Capital In Excess Of Par

  This account balance is the amount of money received by the company, in excess of the par value described above, when the stock is sold to investors.

- Treasury Stock

  This account balance represents the dollar cost of repurchasing shares of stock.

- Retained Earnings

  The balance in this account represents the amount of accumulated profits of the company since inception that have not been paid out to investors in the form of dividends or other distributions.

- A Note on Dividends:

  You should determine which dividends are legally contractual, contractual by precedence, or truly discretionary.

  If an equity security document exists it is important to review it in order to determine the dividend payout terms of an issue. Some issues (typically common stock) carry a discretionary payment structure, but, in many cases (especially in family owned
companies), dividends are expected to be paid and therefore represent fixed costs. If the agreement is not in written form, a review of historical practice and a discussion with shareholders/management will most likely provide the answers.

**TAX STRUCTURE**

The tax status of your customer is significant in the analysis of owner’s equity because it affects the historic and expected profits and cash flow.

There are three major types of business organization structures:

- **Corporations** incur tax liability according to standard provisions of the tax code for corporations. Stockholders are shielded from personal liability for business debts; only their investment is at risk.

- **Partnerships** pass tax responsibility for profits or losses to the partners. Limited partners are shielded from personal liability for business debts, as only their investment is at risk. General partners on the other hand are liable for debts of the partnership.

- **Proprietorship** profits or losses flow through to the owner, or proprietor. Because the two are considered to be one legal entity the owner is fully liable for the debts as well as the taxes of the proprietorship.

**Evaluating Your Customer’s Capital Structure**

**THE IMPORTANCE OF CAPITAL STRUCTURE**

Your customer’s capital structure is important to the bank because it enables you to identify the sources of capital available to the company. Your role in reviewing and influencing the capital structure of a borrower is to preserve the best chance for servicing and repaying bank debt from cash flow, as a primary source of repayment, and from asset liquidation as a secondary source. You should evaluate each source of capital by critically evaluating the liabilities and equity side of the balance sheet, look for flexibility to generate additional capital from each source.

The following are key points to consider when evaluating availability of each major capital source:

**Accounts Payable/Trade Credit**

Recall that an accounts payable increase represents a reduction of cash needs and, therefore, a reduction in the need to borrow bank debt.

An effective working capital management tool may be to take advantage of trade terms offered by suppliers, and in some cases your customer may be able to request extended terms. However, if you notice that accounts payable days on hand are increasing, it is important to find out why. It may be that your customer is simply not paying trade creditors within terms, which if taken to extreme could result in denial of trade credit.

By maximizing trade credit, more cash is preserved for servicing and repaying bank debt, which can, in some cases, significantly reduce interest costs. Maximizing trade credit is particularly important for the following:

- A growing company.

- A company emerging from protection under the Company Creditor Arrangement Act.
• A company whose growth has now stabilized.

**Accrued Expenses**

These expenses are not normally a source of financing on which you focus. However, if it represents a large proportion of liabilities, you should determine the composition of what has been accrued and when it needs to be paid.

**Senior Revolving Debt**

This debt can be in either a seasonal or a permanent working capital loan. For smaller and medium sized companies, it will generally be secured by a floating charge on all assets of the company and may incorporate a fixed charge on specific assets.

If the funds were provided for an acquisition, the debt may often also be secured by a secured or unsecured guarantee from the acquired company and a pledge of its shares or the shares of any or all of its subsidiaries.

**Senior Term Debt**

This debt, again with most middle market or small companies, is also usually secured by a floating charge on all assets of the company with a fixed charge on specific assets. If the Senior Revolving Debt and the Senior Term Debt are provided by the same lender, or group of lenders, it is normally the case that both loans will have the same security and it will rank pari passu. If the revolving credit facility is provided by another institution, that institution will generally be provided a priority agreement on receivables and inventory, and in most instances the amount of that priority is limited by dollar value.

As with the Senior Revolving Debt, if the funds were provided for an acquisition, the debt may often also be secured by a secured or unsecured guarantee from the acquired company and a pledge of its shares or the shares of any or all of its subsidiaries. In both these cases, the usual entity providing the debt will be commercial banks or similar financial institutions.

It is important to understand the maturities of all debt. While Senior Debt may well be that, if another form of debt has a maturity prior to the maturity of the Senior Debt, unless there is a default, that other debt may well be paid in priority to the Senior Debt.

Again, from the senior bank’s perspective, the objective is to ensure that the cash flows of the company are directed first to servicing and second to repaying the senior bank’s debt.

**Subordinated Debt**

Subordinated debt is also occasionally (particularly if there are warrants or convertible features to the subordinated debt) referred to as “mezzanine” debt or “junk” bonds. This debt is usually unsecured or is secured by junior liens on the assets. It is important to be careful with this feature, since rights of junior lienholders, while technically subordinated, may provide those holders with potential leverage in restricting the senior lienholders’ ability to sell or otherwise dispose of the assets at its discretion.

Subordinated debt is usually issued for periods longer than commercial bank debt and often at a fixed rate. Its usual providers are insurance companies, pension and investment funds, or other long-term investors. Principal provisions in subordinated debt may include:

• In insolvency or bankruptcy, the senior bank will be paid out before the junior bank receives any payment.
• Payments of subordinated debt are prohibited if senior debt is in default. Sometimes the rights of the senior bank to block subordinated debt payments can be enforced only for a limited period (90 to 270 days) but usually around 180 days.

• No principal payments are scheduled on subordinated debt until after final maturity on the senior debt.

• The senior bank often seeks the right to have all penalties, fees, and expenses of collection paid before the subordinated bank gets any payment.

• Subordinated debt remains subordinated to allow for refinancings of senior debt.

• Subordinated debt may be expressly subordinated to trade debt, particularly if the senior bank feels trade debt is an important part of the liability structure of the balance sheet.

• Suspension of enforcement rights by the subordinated bank on an event of default may restrict the subordinated bank from taking action against the company on the earlier of a fixed period of time, acceleration of the loan by the senior bank, or the full payment of the senior bank.

The principal objective of these provisions is to protect and preserve the rights of the senior bank to the cash flow of the company for servicing and repaying its own senior debt. It is very important to review the terms and conditions of any subordinated debt to make sure you understand the subordinated creditor’s rights. The principal provisions of subordinated debt listed above may not be identical to those of your customer’s debt, particularly if the customer is a smaller, private company whose subordinated debt is payable to closely related individuals or entities.

As of January 1, 2005, subordinated convertible debt is now considered as debt, and not equity under GAAP. In order to make the determination for ratio calculation of debt measures, you need to understand the terms and conditions of conversion and whether or not interest payments can be made through the issue of shares rather than in cash. If the debt is convertible at the option of the company, you may sometimes be in a position to make an argument to consider it as equity. However, if it is convertible at the option of the debt holder, it is definitely more like debt. If “interest payments” can be made in shares rather than cash at the option of the company that may well be a way to conserve cash. However, you need to keep in mind that if shares fall significantly in value, the company may opt to pay interest in cash rather than dilute the shares in the company.

**Sellers’ Subordinated Debt or Vendor Take Back**

This debt can be in the form of “seller paper” in which the seller of the company takes back a note that is subordinated to the senior bank debt. This can occur in acquisition financing situations as well as in related circumstances such as a transfer of ownership from one shareholder to another. In such circumstances, the seller paper sometimes may be convertible into stock in the company at a later point in time. You need to understand the terms and conditions of the Vendor Take Back to make sure it does not constitute a risk to repayment of your debt.

**Common or Preferred Shares**

This represents the equity owned by the shareholders. For a public company, shareholders range from private individuals to public institutions. In the case of a private company, shareholders usually are individuals or managers. However, when there has been a buyout by management of the public shareholders, the equity holders are a combination of management and selective institutional investors.

**Note:** With respect to the distinction between common and preferred stock, remember that while both are forms of equity and therefore truly rank below senior secured debt, in the case of preferred stock, shareholders may have cumulative rights to dividends. While bank debt usually is structured
so that the bank retains the right to stop such dividends, the feature of accumulation nonetheless represents an incremental drain on the cash flows of the company at the time when such cash dividends start to be paid.

**CAPITAL STRUCTURE AND THE IMPACT OF INTANGIBLE ASSETS**

An alternate perspective on a company’s capital structure lies in analysis of tangible net worth, or quality of the assets that have been acquired with the company’s capital. Lenders commonly adjust net worth to exclude intangible assets as a means of measuring the tangible book value of the company. Measuring tangible net worth is important, as it helps identify the portion of equity that may be realizable in liquidation. This traditional, conservative perspective helps us evaluate the quality of a company’s net worth. Conventional wisdom has long suggested that a company whose net worth is comprised solely of quality tangible assets brings more to the collateral table than a company whose net worth includes significant intangible assets.

However, keep in mind that some intangible assets may provide material potential realizable value, even in a distressed liquidation. For that reason, it is important to understand the nature of a company’s intangible assets and to determine if there may be some additional value in those assets not suggested by their balance sheet values.

For example, balance sheet values of patents, copyrights, and trademarks that were internally developed include only the capitalized legal costs incurred to secure the intellectual property protection. All other development expenses are expensed as incurred, suggesting that for a successful process, publication or trademarked name or product, there may be significant cash value to the intangible asset beyond the amortized balance sheet value. The value of an asset such as a patent or trade name can be determined a discounted cash flow approach. For example, a valuation expert would consider how much revenue the borrower could generate by licensing a trade name, easily assessed if the company already licenses other trade names, but also potentially established by identifying comparable licensing agreements in the current market.

Carefully evaluate your customer’s intangible assets to determine which may have value separate from the borrowing entity (trademarks, service marks, newspaper mastheads, internet domain names, customer lists, customer contracts, literary works, musical works, operating and broadcast rights, patents, databases, and trade secrets are examples). A good hint for identifying intangibles that may have separable value is that these assets are being amortized (compared to goodwill, which is not amortized). These assets may suggest quality of equity not disclosed by balance sheet values.

Alternately, it is also true that many intangible assets are often of dubious value in liquidation, such as goodwill, despite accounting rules that require the asset to be written down when impairment of value has been noted and measured. Justifiable ongoing concern values of goodwill and other indefinite-lived intangibles may bear little relation to their values in liquidation.
ASSESSING CHANGES IN CAPITAL STRUCTURE

Financial managers tend to manage their companies’ capital structures with a variety of objectives in mind. Some of these objectives are:¹

- to retain financial flexibility, such as by limiting current borrowings to preserve access to future debt, or by maintaining a satisfactory credit rating.

- to minimize capital costs, which often means that companies with high marginal corporate tax rates have strong incentives to use debt, to take advantage of its tax deductibility.

- to avoid dilution of ownership, especially in closely held companies.

- to manage tax liability (including owners’ personal tax liabilities when the company is a tax flow-through entity).

- to reduce attractiveness as a takeover target.

Your review of changes in your customer’s capital structure should include assessing any change to the company’s continued ability to service and repay bank debt from cash flow, as a primary source of repayment. Not all priorities noted above are necessarily helpful to debt repayment ability, and your loan structure should incorporate terms and conditions to control additional indebtedness if appropriate.

However, remember that even lender-friendly capital structure changes, such as the issuance of additional equity or subordinated debt may impair the company’s flexibility in the future. For example an issue of preferred shares has the potential to be a cash flow drain to liquidate preferred shareholders’ rights to cumulative dividends. Also consider that issues of stock in closely held companies may feature controls or restrictions that have the additional effect of limiting the pool of talent that will realistically be available to help manage the company.

This section has introduced you to the major balance sheet accounts and their significance in your credit risk analysis. Where you add value to the credit approval process is in understanding these risks and their relative importance in the overall analysis of each customer.

Your analysis of the balance sheet accounts, when coupled with a ratio analysis of asset turnover and efficiency and asset liquidity (convertibility to cash), will provide you with a comprehensive picture of the balance sheet and how the various accounts interrelate to produce cash flow for the business.

To further understand debt capacity, you will need to analyze the company’s profitability.

**Balance Sheet Ratio Analysis**

There are many ratios that can be calculated from a company’s financial reports. To conduct a meaningful analysis, determine which ratios have relevance to your customer’s business and industry. Most ratios measure the profitability, liquidity, and leverage of a company in its normal operating cycle. A ratio analysis must incorporate several years for the analysis to

lead to meaningful conclusions as to the trend, direction, and degree of change from one fiscal period to the next. A note of caution: a ratio analysis does not take into consideration any qualitative evaluation of the numbers. Ratios simply provide you with a numerical measure of the company’s performance, and require you to look behind the numbers to determine what caused any significant changes. Ratios do however allow you to:

• Analyze trends for a company from one year to the next.

• Make a meaningful comparison of one company to another or to a composite of companies such as that provided in the RMA’s Annual Statement Studies.

• Measure your customer’s ability to convert its current assets to cover its current liabilities (using Liquidity Ratios).

• Measure the extent to which your customer utilizes debt to fund its assets (using Leverage Ratios).

In order to ensure comparisons are appropriate, you must ensure that the definitions are consistent. As an example, Quick Assets (as utilized in the next section) have two different definitions. One is simply

Current Assets minus Inventory, and the other is

Cash plus Marketable Securities plus Accounts Receivable.

Should there be significant Other Current assets (for example Prepaid Expenses), these two calculations can provide significantly different numbers. RMA Annual Statement Studies composites use the latter of these two definitions for ratio calculations.

LIQUIDITY RATIOS

Measuring Liquidity: Your customer’s ability to convert its current assets to cash in order to meet its short-term obligations (current liabilities) is analyzed. The disadvantages of liquidity ratios are that they:

• Only indicate change

• Do not indicate whether asset/liabilities are at appropriate levels

• Are based on accrual accounting and do not represent cash

• Provide no insight into the realizable value of the current assets

The four classic measures of liquidity are outlined in the following chart:
<table>
<thead>
<tr>
<th>MEASUREMENT</th>
<th>FORMULA</th>
<th>COMMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>CURRENT RATIO</td>
<td>(\frac{\text{Current Assets}}{\text{Current Liabilities}})</td>
<td>Measures extent to which current assets cover current liabilities; useful for historical and external comparisons. Expected to stay the same or improve over time as inventory and receivables are financed by long-term debt or equity as growth occurs.</td>
</tr>
<tr>
<td>QUICK RATIO</td>
<td>(\frac{\text{Quick Assets}}{\text{Current Liabilities}})</td>
<td>Also known as the “acid test” ratio and is a more conservative measure of liquidity than the Current Ratio. QR&gt;1.0: Current liabilities are covered by Quick Assets (defined by RMA as those assets that can be readily converted into cash at approximately their stated value and calculated as cash plus marketable securities plus accounts receivable); no reliance on inventory to satisfy current liabilities. Expectations are the same as current ratio. QR&lt;1.0: Some inventory must be liquidated to satisfy current liabilities.</td>
</tr>
<tr>
<td>INVENTORY RELIANCE PERCENT</td>
<td>(\frac{\text{Current Liabilities} - \text{Quick Assets}}{\text{Inventory}})</td>
<td>Measures extent to which inventory would have to be liquidated to cover current liabilities, after all quick assets are applied. Expected to decrease over time as inventory is financed with long-term debt or equity as growth occurs.</td>
</tr>
<tr>
<td>NET WORKING CAPITAL</td>
<td>(\frac{\text{Current Assets} - \text{Current Liabilities}}{\text{Current Liabilities}})</td>
<td>Measures the dollar amount by which current assets could shrink in value and still cover current liabilities; useful in focusing on asset distribution and liability structure. Expected to increase as sales increase.</td>
</tr>
</tbody>
</table>

**LEVERAGE RATIOS**

Measuring Leverage: Leverage indicates the extent that your customer utilizes debt to fund its assets. Leverage is important to you because it expresses the margin of protection provided by the owner’s investment in the company’s assets. Remember that liabilities seldom shrink in value, but the market value of owner’s equity will change in direct correlation to the fluctuating market value of assets. The disadvantages of leverage ratios are that they:

- Do not determine repayment ability.
• Do not opine as to the appropriateness of asset/liability levels.

• Are not measures of cash flow.

The four classic measures of leverage are outlined in the following chart:

<table>
<thead>
<tr>
<th>MEASUREMENT</th>
<th>FORMULA</th>
<th>COMMENTS</th>
</tr>
</thead>
</table>
| DEBT TO WORTH                      | \[
|                                    | \frac{\text{Total Liabilities}}{\text{Net Worth}} \] | Basic leverage calculation; measures the direct proportion between debt and owner’s equity; useful in historical and external comparisons; expected to stay constant. |
| TANGIBLE NET WORTH                 | \[
|                                    | \frac{\text{Net Worth} - \text{Intangible Assets}}{\text{Net Worth}} \] | Eliminates potentially least liquid assets (intangibles) from net worth to refine margin of protection.                                       |
| DEBT TO TANGIBLE NET WORTH         | \[
|                                    | \frac{\text{Total Liabilities}}{\text{Tangible Net Worth}} \] | Refines basic leverage calculation to eliminate any margin of protection dependent on liquidation of intangible assets; expected to stay constant. |
| NET FIXED ASSETS TO NET WORTH      | \[
|                                    | \frac{\text{Net Fixed Assets}}{\text{Net Worth}} \] | Measures the extent to which net worth is composed of fixed assets. Lower ratio indicates less dependence on fixed asset values as basis of net worth; expected to stay constant unless the company is making a significant investment in fixed assets. The presence of substantial leased assets (not shown on balance sheet) may deceptively lower this ratio. |
Income Statement Quality Analysis

Analyzing the income statement allows you to evaluate the operating performance of your customer. Profitability can be a key component of a company’s cash flow and ability to repay debt.

In analyzing the income statement, the following questions are appropriate:

• What are the stability and predictability of revenues and expenses?

• Are expenses:
  ➢ Adequate?
  ➢ Fully accounted for?
  ➢ Well controlled?
  ➢ Comparable?

The following will be reviewed in this section on income statement analysis:

• Analyzing Revenues (Sales)
• Analyzing Expenses (Costs)
• Income Statement Ratio Analysis

Analyzing Revenues (Sales)

Are reported sales a true reflection of market demand and what is their potential to be converted to cash? Are historically reported revenues authentic and are they repeatable in the future?

• Operating Revenues
  
  This represents the revenues originating from the day-to-day operations of the business.

• Other Income/Extraordinary Income
  
  Non-operating income is from sources such as rental income, investment income, sale of assets, etc. that don’t relate to ongoing day-to-day operating activities.

Operating Revenues

The purpose of revenue analysis is to determine:

• Are reported sales or income streams a true reflection of market demand with independent parties for the product or services?

• Do these sales have a high probability of converting to cash?

• What are the prospects for sales in the future; i.e. are historic sales levels repeatable?
Key issues to consider when analyzing operating revenues include:

- **Repeatable Revenues** -- How is demand for the product or service expected to change in the future? These revenues are sometimes called “sustainable revenues.”

- **Market Share** -- What is the client’s sales level vis-à-vis the entire market for the product or service?

  Market size and growth rates are difficult to obtain, especially when companies compete regionally, rather than nationally or internationally. The absolute level of sales and percentage of market, as well as growth rate comparisons, are valuable data. A review of the company’s major competitors is critical to understand the nature of the business and how the company competes within its industry.

- **Sales Growth/Decline** (historic and projected)—Are changes in sales a result of:
  - A change in market demand and the number of units sold?
  - Price increases or decreases both from inflationary pressures and changes in market demand?

- **Profit and Cash Flow Implications of Sales Growth** -- Consider whether historic or anticipated sales growth comes at either a profit or cash flow cost to the customer.
  - Is the cost to generate additional sales likely to remain consistent with current costs, or will incremental revenues be less profitable than current revenues?
  - Will the company grow sales through price concessions that will depress margins?
  - What is the implication of sales growth for the company’s working capital needs? Sales growth may require significant additional financing for receivables and inventory if growth is high. In addition, you should determine if additional growth will alter the existing cash operating cycle, as might happen if the company offers more generous payment terms to grow its business. Alternately, growth may be supported by special terms from key suppliers, helping to minimize working capital financing needs.

  For more help on identifying the cash implication of sales growth, see Dimension 4’s discussion of assessing the client’s cash flow.

- **Sales Fluctuations** -- Is the current year sales level depressed or inflated relative to historic levels? Causes for such variations should be analyzed and compared with overall industry changes.

- **Sales Terms** -- Has there been a significant change of the terms (credit or otherwise) under which this product or service is sold?

- **Sales Mix** -- How many products and/or services does the company sell and are there concentrations by product or customer or both?

- **Net Sales** -- How are net sales derived from gross sales as a result of discounts taken and returns and allowances? You should analyze any deviations of:
  - Current levels from historic levels
Current levels from levels that might be expected under the company’s terms of sale

- **Backlog or Unprocessed Orders** – Your customer can supply information on backlog and unprocessed orders.
  
  - What is the absolute dollar amount in this category?
  
  - How does the amount compare to that of prior periods and to plant or operational capacity?
  
  - Given current production levels, how long will it take to fill the current backlog?

**Other Income/Extraordinary Income**

What other recurring or one-time sources of income does your customer have?

**Other Income**

- Interest income from cash equivalents and investments
- Rental income from customer lists
- Real estate rental income

**Extraordinary Income**

Extraordinary income generally relates to unplanned income received from a transaction that will only occur once. Cash flow from this source should not be considered when projecting your customer’s future income stream and debt service capacity.

**ANALYZING EXPENSES (COSTS)**

The objectives of expense analysis are to determine the following:

- What is the nature of the activity resulting in the expense?
- How controllable is the expense?
- Are the dollar amounts in absolute terms and the percent relative to sales level typical for your customer and the industry?
- Is it expected that these expenses will increase/decrease in future periods, and why?
- How volatile are the costs for raw materials or personnel costs for certain skill sets?
- Is the stated expense category fixed or variable?
- Are the accounting methods for recording expenses consistent from period to period (especially inventory valuation methods) and with other companies within the industry?

You can accomplish this analysis by systematically examining each expense/cost category appearing in the income statement and then analyzing those expenses in light of your customer’s historic expense levels, and relative to industry norms, i.e. benchmark to industry data.
Expense categories we will discuss are:

- Cost of Sales/Cost of Goods Sold
- Operating Expenses
- Other Expenses
- Income Taxes
- Extraordinary Expenses
- Comparability of Expenses

**Cost of Goods Sold (COGS)**

COGS is the cost or expense (direct or indirect) to produce the goods or services sold during the period, including materials, labor, and other costs incurred directly in the production process. In some cases, depreciation will be included. It is important for you to understand not only the dollar composition of each COGS category, but also to consider how much of COGS is variable and how much is an allocation of fixed costs.

In a company in which COGS is almost all variable costs, management can control COGS (and therefore cash flow) in times of sales fluctuations. Variable costs increase or decrease with a comparable change in sales, while fixed costs tend to increase in steps (larger increments of sales) as sales grow.

You should analyze the breakdown of fixed expenses to variable expenses to:

- Determine operating leverage—defined as profit after variable expenses/profits before tax. The importance of operating leverage is discussed later in this Dimension.

- Determine the company’s ability to adapt to changing sales levels.

- Identify the existing and potential breakeven sales level—defined as total fixed expenses/profit after variable expenses as a percentage of sales. Note that for business case purposes, total debt payments may not be included in the analysis, although interest payments may be. However, as lenders, we need to understand what the breakeven sales level is which not only pays all operating expenses, but also repays any scheduled principal and interest payments on debt. For that reason, total debt payments are normally included as a fixed expense when calculating the breakeven sales level.

For a more detailed discussion of operating leverage, distinguishing between fixed and variable expenses, and the break-even point, see the discussions ‘A Note about Operating Leverage’ and ‘Cost Structure Measures’ later in this Dimension.

When examining COGS, you should refer back to the discussion about inventory and accounts payable, the balance sheet “buddy accounts” to COGS, and analyze the following:

- What is the inventory—raw materials, work in process, or finished goods?

- What is the inventory’s current market value and method for valuation and what would be its value in a liquidation mode?
• Does the company take available discounts on accounts payable to reduce funding costs?

• Is there any stale inventory (old and not saleable), and has the company utilized their suppliers’ returns and allowance policies to eliminate any unusable or damaged inventory?

The mathematical calculation for determining COGS is:

\[
\text{Beginning Inventory + Purchases = Total Available for Sale - Ending Inventory} = \text{Cost of sales}
\]

This formula works well for wholesalers, distributors, and retailers. For manufacturers, the “purchases” number needs to include raw materials plus manufacturing and assembling costs.

Errors in the beginning or ending inventory numbers and their method of calculation will affect COGS as follows:

• If ending inventory is overstated (through error or choice of accounting method), then COGS is understated and profits are overstated.

• If ending inventory is understated, then COGS is overstated and profits are understated.

**Operating Expenses**

Operating expenses can be defined as those expenses that are necessary to run the company that are not included in COGS. Operating expenses are expenses that support the infrastructure of the company and are generally described in two broad categories:

• Selling Expenses: expenses necessary to develop, package, market and sell the product or service

• Administrative Expenses: expenses relating to the overhead costs of the company

Within these two categories there are:

• Discretionary and non-discretionary expenses

• Fixed and variable costs

These concepts are important because they identify expenses that can be controlled by management. How these expenses are managed can give you a view of the financial administration and discipline of the company.

**Discretionary and Non-discretionary Expenses:**

The differences between discretionary and non-discretionary expenses relate to the necessity of incurring the expense in operating the company and are defined as follows:

• If the expense is absolutely necessary to keep the company in operation, then the expense is categorized as non-discretionary.

• Discretionary expenses are those expenses that typically make running the company easier or more enjoyable. When there is a downturn in the company’s performance, these discretionary expenses can be reduced. Often your view, and the view of your customer, of an expense as discretionary are quite different. Accordingly, it is best if you
identify these expenses in an unobtrusive manner in discussions with management during the process of developing the relationship so there are few surprises if such discussions arise in earnest later on in the relationship.

**Fixed and Variable Costs**

Fixed costs and variable costs relate to how costs are incurred relative to the number of units produced and sold. A good cost accounting system identifies three types of cost behaviors, or modes by which costs react to changes in unit sales:

- **Variable costs**, which change in total in direct proportion to changes in activity. Examples include direct materials, direct labor, cost of goods sold when evaluating a distributor, and sales commissions.

- **Fixed costs**, which remain constant in total throughout the range of sales activity in which the company expects to operate. Examples include property taxes, hazard insurance, *depreciation, rent, and office staff salaries*.

- **Mixed costs** (also called semi-fixed costs), which contain both a variable and a fixed element. The fixed element is the basic charge for having the service ready and available for use. The variable cost element is a consumption charge. One example is telephone expense for a telemarketer, which include basic line service fees (fixed) plus usage fees based on call volume. Another example is management compensation that includes a base salary plus additional amounts tied to company performance, particularly if the performance metric is heavily weighted by sales volume.

Mixed costs must be separated into their fixed/variable components to allow for an accurate break-even analysis and to measure operating leverage (explained below). Accomplishing this separation ranges from simple inspection over time (which expenses tend to change as a result of sales variation?) to more complex statistical analyses including linear regression analysis. This technique requires a computer model to analyze company expenses, looking for any statistically significant cause-and-effect relationships between an independent variable (for example, revenues) and one or more dependent variables (for example, salaries, utilities, etc.).

As a practical matter, lenders are not generally able to accurately distinguish between a company’s fixed and variable expenses based solely on the customer’s financial statements. It is a mistake to assume that all cost of goods sold or all operating expenses are variable, as a closer look typically reveals that these are a mix of fixed and variable expenses, particularly for a manufacturer. It is important to consider the likely broad mix of fixed and variable expenses, so you can check for risks related to operating leverage and break-even analysis, which will be detailed below. Be aware, however, that the quality of that analysis will always be limited by the quality of information you can secure from your customer about the borrower’s cost behaviors. When in doubt, the more conservative approach is to consider costs as fixed.

*A Note about Operating Leverage*

The balance between a company’s fixed and variable expenses is the underpinning of its Operating Leverage.
Operating leverage indicates the relationship of fixed operating expenses to total operating expenses before considering costs associated with debt. Expressed as a percentage, operating leverage serves as a barometer for a company’s susceptibility to business risk. Higher levels of operating leverage are usually coincident with higher business risk, in that earnings available to pay debt service dissipate more quickly as revenues decline in a company with high operating leverage compared to one with lower operating leverage.

However, keep in mind that companies with high operating leverage have substantial upside profit potential once they have covered their fixed expenses. That is because a high proportion of fixed expenses (and thus minimal variable expenses) means each dollar of revenue beyond the break even point has very few variable expenses to cover and thus is highly profitable revenue.

Your most important consideration when evaluating a company’s high operating leverage is the likelihood of a rapid reduction in revenues, as the company will have limited flexibility to respond if sales drop rapidly, approaching or dropping below the break-even point. It is vital to understand the key drivers of revenue for the company and its industry, so you can have your own opinion about risk of a serious sales decline and thus the impact the company’s cost structure (fixed versus variable) on its ability to survive such a reversal.

When evaluating the potential risk implication of a company’s operating leverage, you should engage company management in a formal discussion of the firm’s cost accounting system and its methods to capture information needed to accurately distinguish between fixed and variable expenses. Then, discuss the company’s break-even analysis, or perform your own break-even analysis based on fixed and variable expense components provided by the customer.

**Other Expenses**

This category includes miscellaneous expenses that are not specifically identified with other items on the income statement. Determine the source and magnitude of the expense and whether it is material to your analysis.

**Income Taxes**

These expense categories relate to the Jurisdictional, and local taxes levied on the income of your customer based upon the tax laws in effect for the particular legal structure and the tax domiciles within which it operates. The effective tax rates vary for any given company from year to year and for similar companies in the same year. To improve comparability, you might use profit before tax (pretax income) for trend analysis and industry comparisons.

**Extraordinary Expenses**

This special classification is used to report non-operating gains and losses. Since these items are unusual in nature and occur infrequently, they are set out separately to aid the analyst in evaluating the profit performance of the business. To include them in the usual, regularly recurring revenue or expense categories would lead you to believe they are normal and will occur again in the future.

**Comparability of Expenses**

Before you complete your analysis, determine if expenses have been consistent from year to year and if they are comparable to other companies in the industry. If expenses are not comparable, trend analysis and comparisons could be misleading.
To evaluate the comparability of expenses, examine two areas in particular:

- Accounting methods such as inventory costing methods, depreciation and useful life assumptions for fixed assets.
- Business practices such as employee benefits or equipment maintenance and/or sinking fund contributions.

**Assessing Quality of Earnings**

As you evaluate the individual components of your customer’s earnings, another dimension of creditworthiness to consider is the customer’s quality of earnings (or income). By quality of earnings, we mean that a company’s net income is dependable and that its measurement has been conservative within the range of revenue and expense accounting choices allowed by generally accepted accounting principles.

Assess the dependability of net income by considering:

- How stable and predictable have revenues been in the past? How vulnerable are revenues to market changes, and in what ways does company management show itself capable of responding to those changes?
- How disciplined has company management shown itself in controlling cost of goods sold and operating expenses?

Assess conservatism by considering:

- Has the company elected to embrace generally accepted accounting principles, even if not providing you with fully audited financial statements? If not providing audited statements, has the company demonstrated willingness and ability to provide supplemental reports and measures, such as agings, and perhaps audit-level procedures for inventory or other assets that are your collateral? Does the company comply with requests for disclosures not traditionally provided outside a full audit?
- How conservatively has management positioned its accounting practices within the range of acceptable GAAP guidelines? For example, a company must use the allowance method to account for bad debt expense to be in compliance with GAAP, but management has significant latitude in deciding how much to add to the bad debt reserve each year. Companies must apply an impairment test to intangible assets, but there is wide discretion in how to devise the test. In these and other cases, companies that choose to be conservative within discretionary ranges have more conservative balance sheets and report more reliable earnings than companies that are aggressive in their accounting choices.

**Identifying the Company’s Base Earnings Profile**

Another important perspective to income statement analysis is to identify the revenues and expenses that truly represent company’s fundamental ongoing earnings capability. The financial statements of larger companies often segregate revenues and expenses related to discontinued operations, or report one-time or unusual charges, such as restructuring charges when a company downsizes its operations. When analyzing a company whose reported earnings include such performance components, recognize that traditional ratio trend analysis, especially when used to establish likely projected performance, may suggest misleading conclusions. It is important to identify the company’s base earnings profile to determine the most likely basis of financial performance going forward.
To identify the base earnings profile means to eliminate any non-recurring revenues and expenses from the income statement, ideally after adjusting for any income tax effect of the elimination. Public companies mindful of the effect of earnings releases on stock prices often provide supplementary exhibits that reconcile the ‘old’ reported earnings with what the company deems to be ‘core’ earnings. For private companies, you may need to perform this assessment on your own.

Standard & Poor’s has developed a core earnings model that can help isolate non-recurring transactions from the central question of earnings repeatability. In its publication, “Measures of Corporate Earnings,” S&P explains its approach to determining core earnings as part of its ratings analysis.

S&P notes that Core Earnings focus on a company’s ongoing operations, including all revenues and costs associated with those operations and excluding revenues or costs that arise in other parts of the business. The following chart summarizes S&P’s ‘Core Earnings’ specific inclusions and exclusions for common transactions:

**Standard & Poor’s ‘Core Earnings’**

<table>
<thead>
<tr>
<th>Included In Core Earnings</th>
<th>Excluded from Core Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Employee stock option grant expense</td>
<td>• Goodwill impairment charges</td>
</tr>
<tr>
<td>• Restructuring charges from ongoing operations</td>
<td>• Gains/losses from asset sales</td>
</tr>
<tr>
<td>• Write-downs of depreciable or amortizable operating assets</td>
<td>• Pension gains</td>
</tr>
<tr>
<td>• Pension costs</td>
<td>• Litigation or insurance settlements &amp; proceeds</td>
</tr>
<tr>
<td>• Purchased research and development expenses</td>
<td>• Reversal of prior-year charges and provisions</td>
</tr>
<tr>
<td>• Merger/acquisition related expenses</td>
<td></td>
</tr>
<tr>
<td>• Unrealized gains/losses from hedging activities</td>
<td></td>
</tr>
</tbody>
</table>

S&P’s rationale for the inclusions/exclusions can be summarized:

- Inclusions:
  - Employee stock option grant expense. S&P’s position is that all parts of employee compensation, including stock options, should be included in Core Earnings. S&P cites research that suggests options expense could lower Core Earnings by as much as 10%.

A new FASB rule in the U.S. requires public companies to deduct stock option expense from earnings beginning in July 2005, and private companies beginning January 2006. For historical years not covered by the new rule, the required footnote disclosure provides information needed to adjust core earnings if the company does not deduct option costs directly from earnings. The Accounting Standards Board of

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Canada has advised that once FASB issued its ruling, it is likely that CICA Section 3870 would be amended to ensure the requirements are parallel in Canada and the U.S.

- **Restructuring charges from ongoing operations.** S&P’s position is that these charges should be included in Core Earnings because they relate to costs and expenses of activities involved in the process of creating products or services. Examples include employee layoffs, maintenance costs, early lease terminations related to plant/facility closings. S&P notes that restructuring charges are “real expenses. The benefit comes in future years: after the plant closings, employee reductions, lease terminations, and other adjustments, the business’s operating costs are lower. If there had been no restructuring activity and no restructuring costs or expenses, there would have been larger costs charged against future revenues in later years.”

- **Write-downs of depreciable or amortizable operating assets.** S&P’s position is that write-downs, even if one-time events, represent the accelerated reduction in the value of assets that would have been used up in the creation of operating revenues. As operating assets they contributed to operating earnings, so the reduction of value should be deducted from Core Earnings.

- **Pension costs.** S&P’s position is that all parts of employee compensation, including pension costs, should be included in Core Earnings. Pension costs arise because people are hired to work and to help produce Core Earnings. However, S&P does exclude some components of reported pension costs.

  Pension costs are generally not identified separately on the income statement and are included in administrative expenses. However, required footnotes detail the expense components. In addition to the pension servicing cost for the year, pension expenses include interest, amortization, benefits paid, settlements, and actuarial gains and losses for the year. S&P excludes some of these components from Core Earnings, most notably expected returns on plan assets and recognized actuarial gains. Generally speaking, the only costs that S&P includes are service costs and interest costs, but the latter is included only to the extent that they are not covered by actual returns on plan assets.

- **Purchased research & development expense.** S&P’s position is that these charges should be included in Core Earnings (instead of being capitalized) to mirror the treatment of internally developed R&D costs.

- **Merger/acquisition related expenses.** S&P’s position is that M&A fees should be included in Core Earnings, because M&A activities are normally undertaken to support a company’s core business activity.

- **Unrealized gains/losses from hedging activities.** S&P believes that these gains and losses should be included in Core Earnings because they protect the future value of operating assets and liabilities.

- **Exclusions:**

  - **Goodwill impairment charges.** S&P believes that write-offs related to the impairment of goodwill should not be included in Core Earnings, because “since a goodwill impairment implies that the company’s earnings will suffer in the future, including a charge for goodwill impairment in Core Earnings would doubly penalize the company’s performance.”
Gains/losses from asset sales. S&P believes that Core Earnings should not include these gains/losses because companies are not in the business of buying and selling their operating assets, with exceptions noted for firms such as real estate companies that do indeed trade in assets as normal activity.

Pension gains. S&P’s position is that pension gains should be excluded from Core Earnings because they are the product of the financial markets and are not available to the corporation’s shareholder.

Litigation or insurance settlements and proceeds. S&P’s position is that gains or losses from litigation or insurance settlements do not arise from the course of normal business. In the same light, S&P excludes provisions to increase litigation settlement reserves. Insurance costs or proceeds are excluded when the insurance is not integral to operations (such as life insurance on employees other than included in employee benefits).

Reversals of prior-year charges and provisions. S&P believes that reversals of expenses such as prior-period restructuring charges distort income because they relate to prior operating periods. S&P does not retroactively restate the earlier year’s overstated charges.

Note that not all analysts agree with S&P’s inclusions/exclusions. Goldman Sachs commentary disagrees with excluding pension gains. However, Moody’s takes an approach similar to S&P on the pension issue. Our purpose in reviewing the S&P Core Earnings approach is to provide a reminder that non-operating income and expense can distract from the central question of whether a company’s fundamental business activity will support debt repayment.

Your customer may have other non-recurring income or expenses that suggest additional adjustment to the company’s base earnings profile. Adjusting your trend analysis to reflect these adjustments is particularly helpful when creating financial projections and performing sensitivity analysis to test repayment ability against the range of likely future outcomes.

**Income Statement Ratio Analysis**

Following the analysis of the absolute level of income and expenses, look at a few key ratios that will help evaluate the company’s financial performance over a number of years. When reviewing ratios for a particular company, compare the company’s profit, coverage, and productivity ratios to:

- The same ratio for the company in prior periods (at least three years).
- The same ratio for other companies within its industry.
- The same ratio for similar sized companies. RMA’s *Annual Statement Studies* provide a means to make comparisons within industries by size ranges.

Income statement ratios we will discuss are:

- Profit Margins
- Cost Structure Measures
- Coverage Margins
- Financial Productivity

**PROFIT MARGINS**

Profit margins express profits (after various categories of expense have been satisfied) as percentages of net sales. Expressing profits as margins facilitates trend analysis and industry comparisons.

**Net Profit Margin**

This is the profit margin after all expenses and taxes have been paid, but before dividends.

\[
\frac{\text{Net Income}}{\text{Net Sales}} \times 100 \text{ (%)}
\]

The net profit margin expresses net income as a percentage of sales.

**Significance:**

- Net income (net profit after extraordinary items and tax) measures the overall profitability of a company after all income and expense items have been accounted for.
- Over a period of several years, net income represents the economic success of the company and is a key component of cash flow.
- Net income is a primary source of equity and therefore has an impact on leverage and growth potential.

**Limitations:**

- Net profit margin is affected by tax rate strategies and extraordinary income or expense items, so results for any one-year can be misleading. For that reason, it is sometimes more valid to use profit before extraordinary items and tax as a percent of sales, thereby excluding the effects of extraordinary items.
- Net profit margin, because it is “bottom line” and the result of all other entries to the income statement, does not help you decide why a company has a particular amount or trend of profits.

**Pretax Profit Margin**

This is the profit margin after all expenses but before taxes and dividends.

\[
\frac{\text{Profit before Tax}}{\text{Net Sales}} \times 100 \text{ (%)}
\]

The pretax profit margin expresses profit before income taxes as a percentage of sales.

**Significance:**

- The pretax profit margin is good for trend analysis and external comparisons because it eliminates the effect of tax strategies and extraordinary income or expense.
Limitations:

- Like the net profit margin, the pretax profit margin does not explain changes in profitability.

**Operating Profit Margin**

This measure represents the profit margin that results from normal operations before extraordinary or other items and taxes.

\[ \frac{\text{Operating Income}}{\text{Net Sales}} \times 100 \% \]

The operating profit margin expresses operating profit as a percentage of net sales.

**Significance:**

Studying the reasons for change in the operating profit margins helps you isolate causes of, and changes in, profitability. Changes in COGS or in operating expenses affect the operating margin.

**Gross Profit Margin (Gross Margin)**

This measure represents the profit margin that results from the mark-up price of the goods or services over cost. It measures how much profit is left in sales dollar after satisfying COGS. It must be sufficient to cover the remaining selling, general, and administrative expenses.

\[ \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 \% \]

The gross profit margin expresses gross profit as a percentage of sales.

**Significance:**

The gross profit margin is an important measure of profitability because cost of sales often represents the largest portion of expenses. It must be sufficient to cover operating expenses and expected profits. To help interpret trends in your customer’s gross profit margin, consider the following questions:

- Have there been any unusual write-downs of inventory value? Writing off stale or impaired inventory is good discipline and required by GAAP, but unusually large write-downs that significantly reduce the gross profit margin should be investigated. A key question to consider is whether the unsalable or excess inventory signals poor sales /quantity planning, poor understanding of market needs or preferences for the product, or a fundamental market shift away from the product in question. It is also appropriate to ask about company policies for verifying inventory accuracy, such as frequency of physical counts. If you are not receiving audited financial statements, there is no assurance that inventory market value or quantity tests are taking place.

- Has there been a change in product mix? Most companies market products with a range of profitability. Has there been a product mix change to respond to shifting market preferences, or perhaps to concede that a strong competitor ‘owns’ a market segment that the customer is no longer able to profitably pursue?
• Has there been a change in pricing strategy? Find out if your borrower has changed price to open a new market, or to respond to competitors’ initiatives. Is the change purposeful, signaling a strategic response to market change, or is it a reactive response to perceived or actual competitive threat without careful consideration of both short- and long-term implications for both sales and profit goals?

• Has the cost of goods sold changed, and if so, is the change temporary or more likely permanent?

• What is the company’s flexibility to improve its gross margin, either through cost control or pricing changes? In other words, is the company’s product or any key component of its goods sold subject to commodity pricing? Does the company have the ability to control the cost of goods sold/ price of goods sold, or are one or both of these inelastic?

Carefully consider the answers to these questions to determine their implication for the customer’s ongoing creditworthiness. Borrowers will always contend with variability in pricing and cost control flexibility. Thoughtful interpretation of the gross margin trend will enable you to assess management’s strategic ability to recognize and respond to market shifts that permanently alter the range of potential gross profit. Remember that today’s loans are repaid through tomorrow’s business performance. Even if recent years’ gross profit trends are strong, it is imperative to engage company management in a discussion of today’s and tomorrow’s pricing and cost landscape to determine susceptibility to gross profit impairment in the near future.

COST STRUCTURE MEASURES

Earlier we discussed the importance of analyzing the relationship between a company’s fixed and variable expenses, to be able to identify potential risk to company profit if sales levels decline suddenly and significantly. We framed that risk in our discussion of operating leverage and the company’s risk of selling below its break-even point. There are three related measures that can help you in this analysis: contribution margin %, the break-even point, and operating leverage %.

Contribution Margin %

\[
\frac{\text{Sales} - \text{Variable Expenses}}{\text{Sales}}
\]

Revenues less variable expenses equals the contribution margin in dollars, which measures the portion of revenue that exceeds variable expenses and thus contributes to the payment of fixed expenses. Expressing the contribution margin dollars as a percentage of revenues enables you to easily compute your customer’s break-even point.

Break-Even Point

\[
\frac{\text{Fixed Expenses}}{\text{Contribution Margin} \%}
\]

For example, if a company’s contribution margin % is 50%, and fixed expenses are $300,000, the break-even revenue point is $300,000 / .5 or $600,000. You can easily see from this relationship that the higher the contribution margin (in dollars and as a percentage of sales), the lower the company’s break-even point. Therefore, the key to consistent, sustained profits is the ability to price high enough to minimize the variable cost component.
of each sale dollar, and of course to exercise discipline over fixed expenses to minimize their consumption of contribution margin dollars. The nature of fixed expenses is that they are indeed ‘fixed.’ However, in reality companies make choices, such as whether to add significant or only modest additional manufacturing capacity, that can alter the balance between fixed and total expenses.

As a Lender, you may want to consider the Contribution Margin with a variation. The break-even point you are interested in includes the payment of principal and interest. The formula then becomes

\[
\frac{\text{Fixed Expenses plus Principal and Interest}}{\text{Contribution Margin \%}}
\]

In the example above, if scheduled Principal and Interest payments total $12,000 per annum, the break-even point including principal and interest becomes $312,000/.5 or $624,000.

**Operating Leverage \%**

\[
\frac{\text{Fixed Operating Expenses}}{\text{Total Operating Expenses}}
\]

The operating leverage \% is a simple tool to gauge a customer’s flexibility risk in the event of a significant sales decline. Monitoring changes in this measure from year to year can suggest not only the flexibility risk, but also may alert you to impending needs for capacity increases. If a customer’s operating leverage \% declines over several years, this may signal that the company is outgrowing its capacity. The measure will grow again when the company invests in new plant and equipment.

When evaluating a company’s cost structure using these measures, keep in mind that asset acquisition choices can influence operating leverage and may explain a change from one year to the next. For example, a company may have formerly leased a retail facility, paying a fixed rent plus a premium based on store sales. When that company relocates to a facility it owns, the variable component of its occupancy expense will disappear.

**Coverage Margins**

Measuring profit margins and studying trends is only part of profitability analysis. To arrive at sound credit decisions, you should calculate profit coverage ratios. These ratios relate profit to payment obligations such as interest, leases, current portions of long-term debt (CPLTD), and dividends. These ratios are indicators of a change or trend, but in no way serve as a substitute for a thorough cash flow analysis.

Under GAAP, certain interest costs can be capitalized and not expensed. However, in order to determine interest expense you must add the capitalized interest to the interest expensed in order to understand the actual amount paid, and use that number in your ratio analysis. The accounting treatment does not change the reality that the interest must be paid from cash.

In the following ratio definitions, we use the terminology of CPLTD, which would generally apply to that account on the balance sheet. However, with recent changes to GAAP, all debt that is demand must be reported as current. In order to calculate coverage ratios, you need
to determine what the scheduled amortization is over the next 12 months in order to make your ratio meaningful and comparable with prior years.

In addition, you need to keep in mind that trend analysis looks back over historical ratios, but if you are planning to provide your client with additional financing you will need to calculate your coverage ratios using projected interest and scheduled debt repayments. Although the added debt is often expected to increase revenues, and therefore cash flow, the conservative approach is to use the cash flow available from the last year-end, but debt servicing requirements on the new debt.

Interest Coverage: There are several variations in calculating Interest Coverage and the credit departments of most financial institutions have a preferred method.

The first method is the one that is consistent with the RMA Annual Statement Studies and allows a comparison with other companies in the same industry. It is calculated as:

\[
\text{EBIT} \quad \frac{\text{Interest Expense}}{}
\]

where EBIT is defined as earnings before interest and taxes. As an alternative, the formula for the numerator adds back non-cash expenses such as depreciation and amortization and also nets out the effects of Extraordinary gains and losses. The formula then becomes:

\[
\text{EBITDA plus or minus Extraordinary gains or losses} \quad \frac{\text{Interest Expense}}{}
\]

where EBITDA is defined as earnings before interest, taxes, depreciation and amortization. The interest coverage indicates the number of times operating earnings in the first instance, or operating earnings plus non-cash net of extraordinary gains or losses, cover interest expense. The higher the interest coverage ratio, the greater the margin of protection within profitability to meet interest expense. When a company’s earnings are volatile, a higher Interest Coverage ratio would be needed to allow for a cushion in the event of a downturn in the financial performance of the company.

**Fixed Charge Coverage**

\[
\text{EBIT} + \text{Lease and Rental Expense} \quad \frac{\text{Interest Expense} + \text{Lease and Rental Expense} + \text{CPLTD}}{}
\]

Or

\[
\text{EBITDA} + \text{Lease and Rental Expense} \quad \frac{\text{Interest Expense} + \text{Lease and Rental Expense} + \text{CPLTD}}{}
\]

A fixed-charge coverage of less than 1 indicates that the company’s profitability is not enough to pay interest, lease, rental expenses, and CPLTD. Note that EBITDA + Lease and Rental Expense is often referred to as EBITDAR.

**Dividend Payout Ratio**

\[
\text{Dividends} \quad \frac{\text{Profit after Tax}}{}
\]
The dividend payout ratio indicates the percentage of profit that is paid to shareholders. Remember that profit is an accrual number and dividends paid is a cash number. A dividend payout ratio that exceeds 100% suggests that a company is paying out more to its owners than it is earning—not an acceptable occurrence to your financial institution as a lender.

**Debt Service Coverage Ratio**

The Debt Service Coverage Ratio ratio indicates the number of times this adjusted net income (traditional cash flow) covers the current portion of long-term debt (CPLTD) as illustrated in the first ratio. The second of these measures how well the Cash Flow Coverage covers both principal and interest and eliminates the effect of any extraordinary gains or losses. The first ratio is the one utilized in the RMA Annual Statement Studies.

\[
\text{Net Income} + \text{Depreciation} + \text{Amortization} + \text{Depletion} \quad \frac{\text{CPLTD}}{\text{CPLTD}}
\]

\[
\text{Or } \frac{\text{Net Profit} + \text{depreciation/amortization/depletion} + \text{extraordinary gains (losses)} + \text{interest}}{\text{Interest Expense} + \text{CPLTD}}
\]

If your client has a significant amount of off-balance sheet financing, such as leases, these ratios can be amended as follows to take into account the servicing requirements on those as well.

\[
\frac{\text{Net Income} + \text{Depreciation} + \text{Amortization} + \text{Depletion} + \text{Lease and Rental Expense}}{\text{CPLTD} + \text{Lease and Rental Expense}}
\]

\[
\text{Or }
\frac{\text{Net Profit} + \text{depreciation/amortization/depletion} + \text{extraordinary gains (losses)} + \text{interest} + \text{Lease and Rental Expense}}{\text{Interest Expense} + \text{CPLTD} + \text{Lease and Rental Expense}}
\]

The proponents of Debt Service Coverage argue that taxes need to be paid before any principal repayments on debt and hence the available amount should be after tax. In addition, non-cash items should be added back as a source of cash.

Both cash flow coverage ratio and debt service coverage ratio are based upon accrual numbers; you are encouraged to analyze cash flow margin and coverage ratios as well. Cash flow statement-based coverage measures are discussed in Dimension 4.

**Financial Efficiency Analysis**

Financial efficiency is the ability of a company to generate sales from its assets. You measure it by calculating turnover ratios that relate sales or cost of goods sold to selected assets. The higher the turnover ratio, the more efficiently the company is using its assets.
High asset efficiency is important to a company’s creditworthiness because it influences:

- Adequacy of profit margins—companies with high asset efficiency can generate the same dollar profits with lower profit margins than companies with low asset efficiency.

- Requirement for assets—high asset efficiency means a lower requirement for assets and a lower borrowing need to support sales growth.

The turnover ratios that relate sales or cost of goods sold to assets are useful in evaluating cash requirements and management actions, but they do have limitations. These limitations mean that turnover ratios:

- Are not as useful for companies with low asset requirements, such as service companies.

- Can obscure or be obscured by seasonality.

- Imply incorrectly that an average turnover rate applies to all assets in the category.

To interpret the asset turnover ratios, follow these four steps:

1. Decide if the ratio is useful, based on the type of company and its investment in various assets.

2. Decide if the ratio is distorted by any seasonal fluctuations and compensate if necessary by using average asset levels.

3. Analyze the trend and identify the reasons for significant changes.

4. Compare the ratio to industry composites or to major competition, and identify the reasons for and significance of variations.

**HOW TO ANALYZE THE FOUR ASSET TURNOVER RATIOS**

**Net Sales to Assets**

To calculate total asset turnover, use this formula:

\[
\frac{\text{Net Sales}}{\text{Total Assets}}
\]

Expect the net sales-to-assets ratio normally to be very stable. The ratio may be less stable during periods of high sales growth or sales declines, either because fixed-asset expenditures are leading or lagging sales or because the relationship of current assets is likely to change when large changes in sales levels occur.

The higher the ratio, the better. Companies that can sustain higher total asset utilization than their competition can be more profitable and can increase sales with less new asset investment. These advantages are success factors for the companies and margins of protection for their lenders. Keep in mind, however that there are two cautions to observe when interpreting this ratio:
• Industry comparison of this ratio is important because asset turnover varies widely with the type of business.

• Trend analysis of this ratio is important because improvement in the ratio can mean the company is on the verge of needing additional investments in current or long-term assets, that it depreciates assets more rapidly than the industry, or that it uses more operating leases.

**Net Sales to Net Fixed Assets**

To calculate net fixed assets (NFA) turnover, use this formula:

\[
\frac{\text{Net Sales}}{\text{Net Fixed Assets}}
\]

The sales-to-NFA ratio is particularly useful in analyzing fixed asset-intensive companies. It is less stable than the sales-to-assets ratio because a company’s acquisition or disposal of fixed assets is not exactly in step with sales at all times.

The higher the ratio, the better, because it usually means the company has fixed assets that are contributing to its ability to make sales. However, it can mean the company has inadequate plant or equipment and may need to make large expenditures to keep up with competition.

A ratio that is declining or that is low compared with the industry can mean the company has invested in assets that are not helping it make sales.

To identify if changes are more from a rise or fall in sales levels or from acquisitions or reductions in fixed assets, examine:

• Net fixed assets as a percent of total assets.
• Changes in sales levels from year to year.
• Amounts added to net fixed assets each year.

**Net Sales to Accounts Receivable**

To calculate accounts receivable turnover, use this formula:

\[
\frac{\text{Net Sales}}{\text{Accounts Receivable}}
\]

Divide net sales for the year by receivables outstanding at the end of the year to evaluate if:

• Customers are paying within terms.
• The company is sending out bills on time.
• Collection efforts are succeeding.
A high ratio means the company collects cash from its credit customers more quickly than companies with lower ratios. Changes in the ratio can mean the company has changed its terms, its credit standards, its billing procedures, or its collection efforts.

The ratio is subject to seasonal distortions. To eliminate seasonality, use the average of monthly or quarterly accounts receivable. To calculate the ratio using interim statements, first annualize the sales—and beware of seasonal distortions.

**Cost of Goods Sold to Inventory**

To calculate inventory turnover, use this formula:

\[
\frac{\text{Cost of Goods Sold}}{\text{Inventory}}
\]

Use cost of goods sold to calculate inventory turnover because it eliminates the effect of the markup (gross profit margin) when inventory is sold.

This ratio is particularly useful for businesses that have a high percentage of assets in inventory.

A high ratio means the company has cash tied up in inventory for a shorter period than companies with lower ratios. Improvement in this ratio often occurs when a company experiences strong sales growth because inventory can barely keep up with demand.

Eliminate the effect of seasonal inventory levels by using a monthly or quarterly inventory average.

**TURNOVER ANALYSIS AND LIQUIDITY**

The relationship of sales or cost of goods sold to elements of the balance sheet (assets, accounts payable, and net working capital) is a form of efficiency analysis that enhances your analysis of liquidity. Four measures are particularly useful in liquidity analysis:

1. **Days’ sales in receivables.**

   For example, assume sales are $5 million and receivables are $500,000.

   First, calculate the net sales-to-receivables (receivables turnover) ratio, shown above. Then divide the days in a year (365) by that ratio.

   \[
   \frac{365}{10} = \frac{\text{(Days in a Year)}}{\text{(Sales to Receivables)}}
   \]

   Overall the calculation is

   \[
   \frac{\text{Net Accounts Receivable}}{\text{Net Sales}} \times 365
   \]

   The result of this example is 36.5 days’ sales in receivables.
Days’ sales in receivables is the average length of time a company has cash tied up in customer accounts, not the actual length of time it takes to collect each account.

Use the measure to quantify the impact on cash that occurs when accounts receivable turnover improves or worsens. In the example above, changing the turnover to 37.5 days would require an additional investment of $13,699. This is calculated as one day of sales or $5,000,000 divided by 365.

Compare the days’ sales in receivables to the company’s selling terms to see how customers are paying on average, but remember it is an average and can conceal delinquencies.

Large allowances, such as for returned items, or large charge-offs can make the measure look better when, in fact, there is a problem that could weaken creditworthiness.

Be sure to compensate for seasonality of receivables by using monthly or quarterly averages before placing any reliance on the measure.

2. Days’ cost of goods sold in inventory.

For example, assume cost of goods sold (COGS) is $4 million and inventory is $375,000.

First, calculate the ratio of COGS to inventory to produce inventory turnover, shown above, and then divide the number of days in a year by that ratio.

\[
\frac{365\text{ (Days in a Year)}}{10.67\text{ (COGS to Inventory)}}
\]

The overall formula becomes:

\[
\frac{\text{Inventory}}{\text{COGS}} \times 365
\]

The result of this example is 34.21 days’ COGS in inventory.

Days’ COGS in inventory is the average number of days a company has cash tied up in inventory, between the time it is received and the time it is sold. It is not a measure of how long it takes to sell each item of inventory.

Use days’ COGS in inventory to measure the effect on cash of increases or decreases in the rate of inventory turnover. In the preceding example, if inventory turnover slowed by 1 day, an additional investment of $10,959 would be necessary, which represents one day of cost of goods sold or $4,000,000 divided by 365.

Anything that affects the amount at which inventory is reported on the balance sheet, such as the use of LIFO or FIFO accounting, will affect the ratio of COGS to inventory, the measure of days’ COGS in inventory, and the apparent effect on cash.

Because the measure is influenced by seasonal inventory levels, try to use averages of monthly or quarterly inventory figures.
3. **Days’ purchases in accounts payable (Accounts Payable Days)**

To calculate days’ purchases in accounts payable, first use the formula for accounts payable turnover:

\[
\frac{\text{COGS}}{\text{Accounts Payable}}
\]

Then divide this number into the number of days in the year.

\[
\frac{365}{\text{Payable Turnover}}
\]

Example: If purchases are $4 million and accounts payable are $300,000:

\[
\frac{4,000,000}{300,000} = \frac{365}{13.33} \quad \text{Or} \quad 27.38
\]

Overall the formula becomes:

\[
\frac{\text{Accounts Payable}}{\text{COGS}} \times 365
\]

The result of this example is 27.38 days’ purchases in accounts payable.

**NOTE:** The traditional financial analyst’s formula for determining accounts payable days uses purchases in the turnover numerator. However, as a practical matter, we often do not have access to a company’s purchases, which is only one component of Cost of Goods Sold. Using purchases, if it is available, is entirely appropriate, because the measure concerns itself with the borrower’s management of its trade credit.

Without purchases information, analysts use Cost of Goods Sold as a substitute for purchases when measuring A/P turnover and the related A/P days. Although this is common practice (and automated spreading systems always capture COGS in place of purchases for these measures), be aware that for manufacturers, using COGS in place of purchases overstates the amount of goods purchased and thus understates the number of days’ purchases in accounts payable.

Using COGS to substitute for purchases for retailers and distributors more closely resembles a purchases-based computation, because in large measures, the goods sold closely equal the goods purchased. However, for these companies, it will be yet more accurate to estimate purchases by using the formula COGS + ending inventory – beginning inventory = purchases.

Use the accounts payable days measure to quantify the effect on cash that occurs when the availability of trade credit changes. In the above example, if one fewer
day’s purchases could be supported by accounts payable, the company would require an additional $10,959 (derived by dividing $4 million by 365 days).

Keep in mind some limitations of this ratio tool:

- Days’ purchases in payables are averages and can mask late payments or lost discounts. To compensate, be sure to obtain an aging of payables and to know a company’s payment terms.

- Measures of accounts payable activity can be distorted by seasonally high payables or by receipt or payment of a very large bill just before the statement date. To compensate, use average payables when you can and always remember that, at times during the year, the company may be borrowing more or less cash from its suppliers than at the statement date.

4. Sales to net working capital.

To calculate sales to net working capital (net working capital turnover), use this formula:

\[
\text{Sales to Net Working Capital} = \frac{\text{Net Sales}}{\text{Net Working Capital}}
\]

This turnover ratio expresses a company’s balance sheet liquidity (the excess of current assets over liabilities) in relation to its income statement. It is useful in comparing the liquidity of two companies of different sales size and in analyzing working capital trends.

A moderate ratio, compared with the past and with the industry, suggests that the company has a cushion to absorb temporary delays in receivables collection or inventory sales. A very high ratio suggests that the company may be struggling to meet its current obligations, and there is little cushion to absorb further cash requirements.

After adding efficiency analysis to your skills, you have these tools to evaluate liquidity:

- Days’ sales in receivables.
- Days’ COGS in inventory.
- Days’ purchases/COGS in accounts payable.
- Sales to net working capital.
- Liquidity coverage ratios—current and quick ratios, inventory reliance percent.
- Current asset accounts as percentages of total assets.
- Asset-quality analysis and characteristics of liabilities.
Financial Productivity Analysis

These ratios measure a company’s productivity, i.e. the ability to generate profits from its assets. They relate profit to assets and net worth and are just another way to evaluate profitability.

Strong financial productivity is important because it:

- Provides owners with a reward (return) for putting their investment capital (equity) at risk.
- Gauges the earning power of the company’s total resources (assets) regardless of whether its assets are supported by equity or debt.

Return on Assets (ROA)

Return on assets measures the profitability generated for every dollar of assets.

\[
\text{Profit after Tax} \div \text{Total Assets}
\]

Significance:

- ROA indicates the:
  - Burden on profit margin as interest expense increases with additional debt.
  - Potential pressure on profitability if assets increase faster than sales.
  - Opportunity for added revenue and profit if production capacity (operating assets) expands.

- ROA also takes into account the profitability of sales and management’s ability or failure to:
  - Control and allocate expense dollars effectively.
  - Establish appropriate sales prices.
  - Achieve desirable sales volume.

Limitations:

- Because it uses after-tax profit, ROA can be distorted by tax strategies.
- Using year-end asset values can be misleading when a company’s assets grow or shrink significantly during the year.

The return on assets analysis can be accomplished using any one of the following three variations of ROA:

- Return on Assets = Profit after Tax/Total Assets
• Pretax Return on Assets = Profit before Tax/Total Assets

• Return on Average Assets = Profit after Tax/Average Assets

Which variation you use is not as important as being consistent so that the number is comparable to prior years and to data compiled on other companies.

*Return On Equity (ROE)*

Return on equity measures the profitability for every dollar of net worth. It expresses the total earnings of the company as a return on the owner’s investment.

\[
\text{Profit after Tax} \quad \text{Net Worth}
\]

**Significance:**

• Takes into account all aspects of managing the company.

• Evaluates the attractiveness of an investment to its owners or to potential new investors.

**Limitations:**

• It can be distorted by tax strategies because it uses after-tax profits.

• Year-end equity figures can produce a misleading result if the company’s equity has grown or shrunk significantly during the year.

*Classifying Accounts for Automated Spreading Systems*

INSERT NEW SECTION CLASSIFYING ACCOUNTS FOR AUTOMATED SPREADING

*Comparing Financial Performance with Industry Peers*

INSERT NEW SECTION HERE—TUTORIAL ON HOW TO USE RMA STATEMENT STUDIES COMPOSITES. (ALSO BRIEF MENTION OF ALTERNATE FINANCIAL RATIO RESOURCES)

*Personal Financial Statement Analysis*

You need to understand the “numbers” involved with a personal financial statement when an individual is either guaranteeing a loan (indirect liability) or is the direct borrower.

There are a number of questions that you need to answer when analyzing a personal financial statement. These questions are:

• How are the listed assets titled? Who owns them and has total control over their sale?

• How are the assets valued?
• What is the quality of the assets?

• What is the liquidity of the assets?

• Are all direct and indirect liabilities disclosed?

• Is the financial statement signed and dated by the individual(s) whose assets and liabilities are listed?

When considering credit to an individual, it is important for you to review your expectations of creditworthiness of the individual:

• What is his/her capacity for credit?

• How does the personal financial statement demonstrate that creditworthiness?

You should not place credit capacity expectations on an individual (or group of individuals) that are not realistic in terms of what their financial circumstances can deliver to the credit enhancement process.
As with business financial statements, the personal financial statement divulges potential capacity to pay, but does not address willingness to pay. Additionally, there is perhaps more history of irregularities and fraud associated with personal financial statements than business financial statements (see Financial Statement and Income Tax Fraud). Seldom are personal financial statements Audited, so you do not have the benefit of independent assessment as you do with fully Audited business financial statements.

Personal financial statements come in a variety of formats including those developed by many financial institutions for their own use. The following sections discuss the personal financial statement.

**STATEMENT OF FINANCIAL CONDITION**

This statement presents estimated current values of assets, estimated current amounts of liabilities, estimated income taxes, and resulting net worth as of the reporting date. The accrual basis of accounting is used to develop the statement. With the accrual basis, income is recognized as it is earned rather than as cash is received. Expenses reflect the use of services rather than cash payments.

**STATEMENT OF CHANGES IN NET WORTH**

This statement reports on increases and decreases in the individual’s net worth.

Footnotes elaborate on certain items. In addition, comparative financial statements are sometimes prepared to facilitate comparison between two or more periods.

The following sections will provide you with information to make an accurate and complete financial analysis of your individual customer or guarantor:

- Accounting Principles
- Statement of Financial Position (Balance Sheet)
- Estimating Cash Flow
- Fundamentals of Personal Income Taxation
- Tax Returns and Cash Flow

**Accounting Principles**

A key question to ask about personal financial statements is who developed and checked the personal financial statement? Personal financial statements can be prepared by accountants, financial planners, or the individuals themselves. If prepared by the individual, he/she may use computer-generated reports or fill out the personal financial statement form provided by your financial institution.

**Statements Prepared by an Accountant**

When accountants prepare or examine the statement, they will perform a compilation, a review, or an audit. Accountant-prepared personal financial statements are not often required unless there is some question as to the accuracy of client-prepared statements.

- Compilation Statement
The compilation is the most basic examination. In a compilation, the Accountant uses the individual’s representation of asset and liability values and ensures that the financial statements are free from arithmetic and clerical errors.

Your examination should ensure that generally accepted accounting principles are followed.

- **Review Statement**

In addition to the checks made in the compilation statement, the review statement also includes consideration of the accounting principles used. In a review, the Accountant determines whether the valuation methods are appropriate and tests for unusual relationships among various items on the statement of financial position.

- **Audit**

The audit is the most comprehensive form of examination. When an Auditor performs an audit, he or she issues an opinion as to whether the statement is prepared in conformity with generally accepted accounting principles (GAAP) and evaluates the individual’s internal accounting controls and examines the records.

The Auditor conducts other tests to determine the accuracy and completeness of the information included in the financial statement.

The Auditor will determine that the bases for asset and liability valuation are reasonable and will verify the amounts. If the Auditor is unable to conduct a full range of tests or finds that valuation methods used are not in accord with generally accepted accounting principles, a qualified audit opinion is issued. Auditors also will issue qualified opinions when the individual lacks formal accounting and control systems.

- **Under most circumstances, GAAP requires that financial statements be prepared on an accrual basis, matching revenues to expenses, but there will be occasions when the statements are prepared on a cash basis, and you should be aware if that is the case.**

- **Statements prepared according to GAAP are required for third party reviewers, but special purpose statements, such as those for Income Tax Purposes or other specific purposes may not be. You need to understand any variations from GAAP in order to understand the implications.**

**Statements Prepared by Clients or Others**

Clients (individuals) who prepare their own personal financial statements may be aware of the appropriate procedures. Or they may have absolutely no knowledge of the conventions that should be followed in developing personal financial statements. You can obtain clues quickly by looking at the overall organization of the disclosures and by examining the footnotes for the bases of valuation and other required information as discussed. If the statement does not seem to be prepared by a financially knowledgeable person, you should meet with the client to discuss the basis for asset and liability valuations and determine other key information normally disclosed on the personal financial statement.

Sometimes clients confuse the entity when they prepare their own statements. Personal financial statements must indicate clearly which individuals are covered. If assets or a business are owned jointly, only the portion of these assets attributable to the client should be shown on the client’s personal financial statement. You should be alert to the possibility of double counting by including various assets as both business and personal property. The
owners of a business, for example, may use business vehicles exclusively and tend to think of them as their own vehicles.

**Statement of Financial Position (Balance Sheet)**

The bases for reporting items on personal financial statements differ from those used for business reporting. One of the most important differences concerns the use of current values and current amounts rather than historic costs—the purchased price plus capitalized improvements/modifications. This section describes these and other differences.

**Assets**

Assets are shown as estimated current values, the fair exchange amount less estimated commissions and/or other costs to dispose of the property. This valuation measure can be particularly useful in estimating liquidity. The current value concept represents the principal difference between business and personal financial statement accounting.

Bases used to estimate fair market value include:

- Appraisals.
- Selling prices of similar property.
- Capitalization of earnings or cash flow.
- Liquidation values.
- Historical costs indexed by changes in price for the specific item.
- Reproduction/replacement value.

As examples, selling prices of similar property should be relevant for undeveloped real estate, while the capitalization of earnings approach should be more useful for determining the value of a going business. Since the choice of method is critical, personal financial statements must indicate the basis or method used to determine asset and liability values.

Assets should be shown at their gross value not as a netted amount against the corresponding liability. For example, a personal residence should be shown at its market value with any corresponding mortgage shown as a liability.

Major asset categories and key considerations relating to each are as follows:

- Cash
  
  This asset is reported at the face amount. This category includes cash balances held in financial institutions, money market accounts, and certificates of deposit. To verify, obtain financial institution and brokerage statements.

- Bank Certificates Of Deposit or Guaranteed Investment Certificates
  
  - Financial institution certificates are reported at current values.
  - Evaluation: Certain certificates are subject to penalties if cashed before maturity.

- Marketable Securities
These assets are shown at their market values. If investments in securities are material compared to total assets, and a large portion is concentrated in one or a few specific companies or industries, further verification and disclosure may be required.

- **Verification:** Customers should provide comprehensive brokerage statements, which indicate holdings and any associated margin accounts.

- **Check the dates on financial institution and brokerage statements to ensure that they match those on the personal financial statement.**

- **Evaluation:** It may be necessary to determine if the securities are marketable. Shares are sometimes held in firms that do not trade publicly or are in some way restricted.

- **Notes Receivable**

  Receivables are shown at the discounted amounts expected to be collected. Accrued interest receivable is included with the note.

  - **Evaluation:** Determine reasons for large receivables. If the note replaces an account receivable that was not paid on time, the note receivable may also prove to be uncollectible. Also, check to see that payments are current and that all other terms and conditions are being met.

- **Real Estate**

  The reporting basis is current value, as with other assets.

  - **Verification:** Determine the bases for valuation (appraisal) and evaluate the reasonableness of the method. Appraisals used to provide financing or tax assessment data could be of some assistance. Experts are often available who have experience and certifiable credentials in a particular area of real estate.

  - **Evaluation:** Via an appraisal (or two, if appropriate), determine the marketability of the property. Test for reasonableness between the value indicated and the property’s annualized discounted cash flow. Peripheral influences, including lawsuits and requirements for regulatory approval, can sharply increase or diminish the value of property.

- **Patents, Copyrights, And Other Intangibles**

  These items are typically shown at the discounted expected cash flow (royalty payments). Historic cost can be used for purchased intangibles if no other information is available.

  - **Verification:** Personal financial statements should include descriptions of intangible assets and their estimated useful lives. You should evaluate these expected lives with respect to possible changes in consumer tastes, technology, or other factors.

- **Life Insurance**

  Life insurance is reported at its cash surrender value (CSVLI) less any outstanding loans. The personal financial statement should disclose the face value of the policy (ies).

  - **Verification:** Examine a comprehensive statement from the insurance company that indicates insurable amount, reports cash values less loans, and indicates that all premium payments are current.
Closely Held Businesses

Investments in businesses are also shown at estimated current values. Personal financial statements should disclose the estimated value of an investment in a business as a single item. You may want to request copies of business financial statements that represent a significant amount of the individual’s personal net worth.

- Evaluation: Personal financial statements must indicate the basis for the business valuation. In addition, when the client has a material investment in a closely held business, disclosures should include the name of the company, percentage ownership, nature of the business, and summarized financial information about the business (or complete financial statements on the closely held business attached to the personal financial statement). Consider how the business was valued and evaluate the reasonableness of the method. When the basis is an earnings multiple, the ability to distribute cash should be considered. You should “benchmark” the valuation multiple against other transactions involving similar businesses.

- Investigate significant partnership liabilities and potential liabilities. Partners are jointly liable, and, in the event of a partner’s bankruptcy, the remaining partners are responsible for the bankrupt partner’s share of partnership debts. If the partnership runs into difficulty, the partners may be assessed for their pro rata shares of the partnership debt and may be required to contribute additional funds if other partners are personally bankrupt.

- Check partnership holdings for investments that act primarily as tax shelters. Many tax shelters lost value with tax reform legislation that prohibited the offset of losses against most other categories of income.

- Also, look for “burned-out” tax shelters. Tax shelters initially provide taxable losses that reduce the investor’s personal taxes. Investments in real estate, for example, generally provide losses due to the combination of relatively rapid depreciation and deductible interest payments on the loan. In later years, however, when the property is depreciated, taxes on partnership income can exceed the cash flow received by the partners. Burned-out tax shelters can be particularly serious for investments that were initially designed as tax shelters with little or no economic rationale other than tax reduction.

- If business assets are included with the business and again as individual assets, they are double-counted. This mistake is an easy one to make.

- It is often appropriate to look at an individual’s “outside” net worth or “outside” tangible net worth, particularly if the financial institution is banking both the business and the individual. The “outside” simply refers to the personal net worth less the net worth attributed to the business. This is discussed further under Adjusted Net Worth.

Future Interests

The rights to receive amounts in the future such as social security benefits are reported at discounted amounts. This assumes that they do not require future service by the holder or are not contingent upon a particular event such as disability or death. Information about assets not included in the financial statements, such as pension benefits based on life expectancy, should be disclosed in the personal financial statement.

- Verification: If the future interests are unusual, examine the relevant contracts for key terms and conditions.
• RRSP’s (Registered Retirement Savings Accounts”) And Other Retirement Accounts

These are reported separately from other assets.

➢ Evaluation: In most cases, the entire amount withdrawn is taxable income. Also, penalties may apply if funds are withdrawn prior to a specified age, depending on the type of retirement account. Thus, the amount actually received by the taxpayer may be reduced by taxes and/or early withdrawal penalties.

• Collectibles

These assets generally represent a concentration of the individual’s interest in a specific area, such as antiques, works of art, show livestock, etc. These assets may have considerable value, but the demand may be quite volatile over very short periods of time.

➢ Evaluation: Many collectibles can be valued by recognized auction houses, specialized appraisers, or special interest organizations.

• Vehicles, Boats, Airplanes, Antiques, Jewelry, And Other Personal Items

These assets are reported at current market values.

➢ Evaluation: Many institutions ignore these types of assets because borrowers often overestimate values, and because the condition of the asset can change quickly. In addition, the mobility of these items also diminishes their value as security.

• Contingent Assets

Operating losses are carried forward and other contingent assets are not shown on personal financial statements because the future benefits are subject to uncertainty. Where material, the nature of these assets should be disclosed in the footnotes.

Liabilities

Liabilities are reported at estimated current amounts. This is the present value of the expected future payment or the amount at which the liability could be discharged currently.

Liabilities fall into four general categories:

• Notes Payable

The reporting basis is the discounted amount of cash to be paid. If debtors can discharge the debt currently for a lesser amount, the statement should show this amount. In the case of limited business activities, such as investments in real estate and related mortgages, the personal financial statement usually shows the asset and liability separately. The statement discloses maturities, interest rates, collateral, and other pertinent details.

➢ Evaluation: Determine whether the note provides a balloon or irregular provision for payment. Conditions under which the liability may be payable prior to scheduled maturity should also be considered.

• Commitments
Commitments include items such as alimony or charitable pledges. These are reported at the discounted present amount if there is no requirement of future service by others, if the liability is not contingent upon a particular event such as disability or death of others, and if the commitment is for a determinable amount.

- **Other Liabilities And Contingent Liabilities**

You should always consider the possibility of hidden liabilities not recorded in the financial statement. Personal financial statements should disclose the amounts of operating leases and other non-cancellable commitments not recorded as liabilities. Also, check for contingent liabilities. For example, you need to determine if the client personally guarantees debts of a closely held business or other individual. The claims of these other creditors may precede those of your financial institution.

  - **Evaluation:** Obtain credit reports and conduct the usual checks for outstanding liens. In accordance with RMA’s code of ethics and Jurisdictional legislation, conduct a credit check on the individual(s) with other known creditors. Ensure that appropriate consents as required under privacy legislation are obtained from your client prior to undertaking credit investigations.

- **Estimated Income Taxes**

Estimated taxes are the taxes on gains expected if all assets are sold at their current values and all liabilities are settled at their current amounts. This item is disclosed separately between liabilities and net worth. Personal financial statements include descriptions of the methods and assumptions used to compute estimated taxes. The statement also discloses the tax bases for major assets. Estimated taxes are different than the concept of deferred taxes used in financial accounting for businesses. Estimated taxes are unique to personal financial statements and have no counterpart in business accounting.

- **Net Worth**

Net worth is the balancing amount that relates all the individual’s assets to the stated claims on those assets.

**Statement of Changes in Net Worth**

In addition to the statement of financial position, personal financial statements sometimes include a statement of changes in net worth. This statement shows the major increases and decreases in net worth. It shows how income, changes in the estimated current values of assets and current amounts of liabilities, and other key items contribute to changes in net worth. Net worth can increase for a variety of reasons including income, the rising values of assets, and the payment of liabilities. Losses in asset values are major reasons for decreases in net worth. In interpreting the statement, you should bear in mind that net worth is merely the residual after considering assets, liabilities, and estimated taxes. Net worth is not cash.

**Adjusted Net Worth**

Now that you have reviewed the elements of the various types of personal financial statements, you may want to make certain adjustments to determine your customer’s real net worth. The following are suggested guidelines to adjust the individual’s net worth.
You should adjust personal financial statement balance sheets to reflect amounts expected to be available from the sale of personal assets and amounts needed to cover obligations (including contingencies). Items to consider include the following:

- Reduce securities, inventory, real estate, and other assets to expected liquidation values.
- Eliminate personal items that are either highly portable, highly sentimental, or lose value quickly.
- Eliminate closely held businesses and loans to businesses when the business is the borrowing entity and your customer is guaranteeing the debt. Institutions often require customers to assume liability for business loans. If the business runs into difficulty, it will likely lose value. Thus, you will need to look to other independent sources of cash flow to customers who stand behind business loans.
- Eliminate closely held businesses that provide the customer with a major source of cash flow. When businesses represent major sources of the customer’s income, business difficulties will contribute to personal financial difficulties. If the ability to generate cash flow decreases, business values also decrease. Consequently, if the customer is unable to service debt due to business difficulty, the liquidation value of the business likely will be low.
- Add contingent liabilities and personal guarantees to other debt holders.
- Adjust the provision for estimated taxes on the sale of personal assets.
- Revise estimated taxes to be consistent with these assumptions. One common approach is to assume that the taxpayer liquidates the assets personally and that taxes are paid before cash is available to service debt. If the institution takes the assets directly as collateral, this assumption is too conservative.

**Estimating Cash Flow**

This section outlines an approach to estimating the individual’s cash flow. The procedure, which is quick, but reasonably accurate in most cases, incorporates the following six steps:

1. Start with direct cash flow
2. Ignore gains and losses
3. Adjust for non-cash items
4. Adjust for cash not received by the taxpayer
5. Determine distributions from partnerships
6. Incorporate information from other sources

**Direct Cash Flow**

The estimate begins with salaries, interest, business income, tax payments, and other T1 Income Tax and Benefit Return items that usually reflect cash. Assume these items to be cash and, if necessary, adjust later for exceptions. Skip rents and royalties; they are obtained from a separate tax form. Self-employment taxes are also skipped. These are included in the total federal tax.
Ignore Gains and Losses

Gains and losses measure income, but do not indicate cash flow. The selling prices of assets are shown in several separate tax schedules. Investments in selected assets are also shown separately.

Adjust for Non-Cash Items

Income and expenses do not always indicate receipts and payments of cash. The example below shows how we adjust for non-cash items.

Cash Flow Estimation

Example: The client has the following taxable income:

<table>
<thead>
<tr>
<th>Item</th>
<th>Taxable Income</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue $40,000, received $37,000</td>
<td>$40,000</td>
<td>$37,000</td>
</tr>
<tr>
<td>Paid $40,000 for inventory; sold goods with original cost $35,000)</td>
<td>-35,000</td>
<td>-40,000</td>
</tr>
<tr>
<td>Sold land for a gain – proceeds of $30,000 compare to a $26,000 original cost</td>
<td>4,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$9,000</td>
<td>$27,000</td>
</tr>
</tbody>
</table>

The cash flow also can be obtained by adjusting income:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>$9,000</td>
</tr>
<tr>
<td>Accrued revenue</td>
<td>-3,000</td>
</tr>
<tr>
<td>Increase in inventory</td>
<td>-5,000</td>
</tr>
<tr>
<td>Excess of selling price over gain</td>
<td>26,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$27,000</td>
</tr>
</tbody>
</table>

The first method of determining cash is called the direct method; the second is indirect. Both methods should always point toward the same cash flow. When analyzing tax returns, use either methods.

One common indirect adjustment relates to depreciation, a deduction that does not use cash. It is usually faster to start with total income and add back this non-cash item than to use the direct method and enumerate each cash flow item.

The following example demonstrates the direct and indirect methods of analysis for a sample tax return.
**Direct and Indirect Methods of Cash Flow Estimation**

Example: The individual’s tax situation is as follows:

<table>
<thead>
<tr>
<th>Form</th>
<th>Item</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Summary (Form T1 General)</td>
<td>Dividend income from taxable Canadian corporation</td>
<td>$300</td>
</tr>
<tr>
<td></td>
<td>Interest and other investment income</td>
<td>700</td>
</tr>
<tr>
<td></td>
<td>Net partnership income</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>Farm income</td>
<td>8,000</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>$11,000</strong></td>
</tr>
<tr>
<td>Interest and dividends (Schedule 4)</td>
<td>Taxable amount of dividends from taxable Canadian corporation</td>
<td>$300</td>
</tr>
<tr>
<td></td>
<td>Interest and other investment income</td>
<td>700</td>
</tr>
<tr>
<td></td>
<td>Net partnership income</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>$3,000</strong></td>
</tr>
</tbody>
</table>

| Farm income (Form T2042) | Revenues | $95,000 |
| | Salaries | (40,000) |
| | Supplies | (7,000) |
| | Feed | (12,000) |
| | Travel | (4,000) |
| | Utilities | (5,000) |
| | Depreciation | (19,000) |
| | **Total** | **$8,000** |

**Direct Method Analysis**

| | Cash dividends from taxable Canadian corporations ($300/1.25) | $240 |
Cash portion of interest and other investment income (assuming only half received in cash) | 350
---|---
Cash portion of partnership income (assuming only half paid out) | 1,000
Revenues | 95,000
Salaries | (40,000)
Supplies | (7,000)
Feed | (12,000)
Travel | (4,000)
Utilities | (5,000)

$28,590

The taxable amount of dividends from taxable Canadian corporations is 125% of the actual cash received. In addition, the cash flow must be adjusted for interest and other investment income and partnership income that has been declared, but not yet paid. Depreciation is ignored because the expense doesn’t use cash.

**Indirect Method Analysis**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income from Form T1 General</td>
<td>$11,000</td>
</tr>
<tr>
<td>Subtract non-cash dividend income from Canadian taxable corporation</td>
<td>(60)</td>
</tr>
<tr>
<td>Subtract non-cash portion of dividend and other investment income</td>
<td>(350)</td>
</tr>
<tr>
<td>Subtract non-cash portion of net partnership income</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Add depreciation, a non-cash expense</td>
<td>19,000</td>
</tr>
</tbody>
</table>

$28,590

The indirect method requires only a few adjustments to income to determine the cash flow.

- **Adjust for Cash Not Received by the Taxpayer**

  When partnerships generate cash, the owner does not always receive cash distributions. Instead, the cash is reinvested in the business. Some partnerships distribute cash to the partners while others retain the cash. In both situations, partners are taxed on their
shares of partnership income, even if they do not receive their pro-rata share of the income in the form of cash.

You can separate the cash flow to the individual and partnership by referring to Schedule 4 which shows the partner’s share of business income, interest, dividends, and other amounts earned by the partnership. If the partner was an active partner then a form T5013 Information form, or a copy of the partnership’s financial statements should be included with the tax return.

Distributions from Partnerships

The tax returns for partners show the distributions (usually cash) received from the business. To obtain the relevant cash flow, we substitute these distributions for the partner’s share of income.

• Incorporate Information from Other Sources

Informed cash flow estimates also require non-tax information. This includes:

- Investments in stocks, bonds, and other non-depreciable property. Tax returns only indicate investments that have shown taxable activity.
- Principal amounts paid on loans. Tax returns show only the interest expense, not the principal amount repaid.
- Amounts received on loans made to others. Only the interest revenue is shown on the tax return.
- Self-employed individuals and owners of partnerships include these taxes on the return with other federal taxes.

Prediction and Sensitivity Analysis

Although understanding historic cash flow is important to an informed analysis, you are most interested in tomorrow’s cash flow. While no single set of assumptions will fit all situations, the following are included:

• Ignore one-time activities not expected to recur. Examples include savings withdrawal penalties, fines, and medical expenses. You should be aware that, in some cases, large medical expenses are recurring and large fines sometimes become a regular cost of doing business.

• Generally, assume no purchases or sales of securities. However, if there is a history of fairly consistent purchases or sales, you can assume continuation of previous practices.

• Assume that net depreciable property purchases will continue as in the past (to maintain the size of the business). However, if the business has grown fairly steadily, a constant growth assumption may be more appropriate.

• Assume no new investments in inventory or other assets.

It should be clear that the prediction process involves more than simply setting nonrecurring items to zero. Prediction requires replacement of historic estimates with new numbers.

The treatment of partnerships differs from other structures. Interest income and a number of other partnership revenue and expense items help to determine the partner’s tax, but they do
not reflect cash distributions to the partner. If the partnership’s situation is expected to change, adjust the worksheet only for the new cash distribution expected for the partner. Leave all other items the same.

Another problem concerns taxes. The only way to avoid the possibility of very substantial estimation errors in the tax number is to recalculate the tax return. You may not have the time to do this. The most practical approach is to assume that the tax payment will equal the previous year’s tax liability while realizing that this provides a source of estimation error. If the client’s situation is expected to change significantly, you can quickly estimate the new tax payment on a very rough basis. For example, you can double the tax if income is expected to double.

**FUNDAMENTALS OF PERSONAL INCOME TAXATION**

The purpose of this income tax presentation is to provide background that will help you in understanding tax returns. The income tax rates for 2003 are utilized here for demonstration purposes only and we have included only Federal taxes. Provincial and territorial governments also levy taxes, but each has somewhat different rates and regulations.

- **Tax Rates and Taxable Income**

  Individual tax returns are due on April 30. Tax returns for self employed persons are due by June 15, 2004, but any taxes payable are due by April 30. These returns show the calculation of taxable income and the Federal tax payable. The tax rate depends upon the amount and nature of the income.

<table>
<thead>
<tr>
<th>For single individuals rates in 2003 were:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>On income up to $32,183</td>
<td>16%</td>
</tr>
<tr>
<td>On income between $32,183 and $64,368</td>
<td>22%</td>
</tr>
<tr>
<td>On income between $64,368 and $104,648</td>
<td>26%</td>
</tr>
<tr>
<td>On amounts over $104,648</td>
<td>29%</td>
</tr>
</tbody>
</table>

- **Tax calculation**

  His initial Basic Federal tax payable would be:

  \[
  \begin{array}{|l|l|}
  \hline
  \text{16\% x } $32,183 & 5,149 \\
  \text{22\% x } ($64,368 – 32,183) & 7,081 \\
  \text{26\% x } ($104,648 – 64,368) & 10,472 \\
  \text{29\% x } ($160,000 – 104,648) & 16,052 \\
  \text{Total Federal Tax payable} & $38,754 \\
  \hline
  \end{array}
  \]
However, Federal tax payable is reduced by Federal non-refundable tax credits. These include such things as the basic personal exemption, exemptions for eligible dependents, Canada Pension or Quebec Pension contributions, Employment insurance premiums, Interest on student loans, Tuition and education amounts, medical expenses (up to a defined limit), charitable donations and gifts (up to a defined limit) etc. The total of these tax credits is multiplied by 16% and that amount is subtracted from the calculated Tax Payable from the calculation above to arrive at Basic Federal Tax.

Other deductions to arrive at Net Federal Tax include political contributions, investment tax credits, etc.

Generally, 50% of capital gains are taxable. The taxable amount of dividends from taxable Canadian corporations is calculated by multiplying actual dividends received by 125%. Federal tax payable is reduced by 13-1/3 % of the taxable amount of dividends from taxable Canadian corporations.

- **Total Earnings or Total Income**

  Total income includes employment income (including salaries, wages and tips), commission income, Old Age Security pension, Canada Pension or Quebec Pension benefits, Disability benefits, other pension income, Employment Insurance benefits, business income (from self employment, proprietorships and partnerships), gambling earnings, rental income, dividend and other investment income, Workers’ compensation benefits, Social assistance payments and taxable capital gains. Taxable income begins with total earnings and subtracts nontaxable income, deductions, and exemptions.

- **Deductions**

  Net income is derived by reducing Total Income by allowable deductions. Deductions include such things as business expenses, registered pension plan and Registered Retirement Savings Plan contributions (up to a defined amount), union and professional dues, child care expenses and support payments.

  Taxable Income is then calculated by reducing Net Income by non-taxable allowances such as Limited partnership losses of other years, Non-capital losses of other years, Capital gains deductions, etc.

**Estimated Taxes**

- **Quarterly Payments**

  Taxes of employees on payrolls are withheld from each paycheck. When income is not subject to payroll withholding, the taxes are due in monthly or quarterly installments based on prescribed measurements. Taxpayers estimate the tax expected for the year and pay one-fourth of this amount quarterly or one-twelfth monthly. Canada Revenue Agency will also send out an Installment Reminder if their files indicate that the individual should be paying taxes quarterly. The taxpayer either applies for a refund or pays additional taxes when the tax return is filed. One hundred percent of the tax for the year must be paid in quarterly installments to avoid penalties. Taxes paid should be based on estimated taxes to be paid for the year, the amount of taxes paid the previous year, or the average of the previous two years. Penalties are payable if tax returns are not filed by April 30 and there are taxes due.

- **Estimated Tax Payments**
Example: The client expects to report taxable income of $2,000,000 with taxes payable of $800,000.

Ninety percent of the tax liability is $720,000. Each payment of quarterly installments must be at least: $720,000/4 = $180,000

- Capital Gains and Losses

Gains on the sales of stocks, bonds, and certain other investments are classified as capital gains. Fifty percent of the net capital gain is taxable.

- Net Capital Gains

Example: A corporation sells stocks and bonds during the year with the following capital gains and losses:

<table>
<thead>
<tr>
<th>Investment</th>
<th>Gain or loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment 1</td>
<td>$3,000 gain</td>
</tr>
<tr>
<td>Investment 2</td>
<td>1,000 gain</td>
</tr>
<tr>
<td>Investment 3</td>
<td>10,500 loss</td>
</tr>
<tr>
<td>Net capital gain</td>
<td>$6,500 loss</td>
</tr>
</tbody>
</table>

Capital losses can only be offset against capital gains but not from other income. Excess losses can be carried back three years or forward indefinitely to offset capital gains in the future years.

- Double Taxation

Corporations and shareholders incur a double tax. The double tax stems from the tax payment by corporations on their income and a second payment by shareholders when they receive dividends.

Example: The subject company is a 40% tax rate corporation with taxable income of $10,000. The company distributes all after-tax income to shareholders, which in this case would be $6,000. The taxable amount of dividends from taxable Canadian Corporations that would need to be declared by individual shareholders is the amount received (in this case $6,000) grossed up by 125%. The dividend tax credit for these dividends is calculated at 13-1/3%, which is a direct reduction in taxes payable. Note that only dividends from taxable Canadian Corporations are eligible for the dividend tax credit.

Overall:

| Corporation’s taxable income | $10,000 |
| Corporate tax at 40%         | 4,000   |
| Remaining for shareholders   | $6,000  |

Shareholder declared investment income ($6,000 x 125%) $7,500
Dividend tax credit ($7,500 x 13/1/3%) $1,000

Note that the investment income of $7,500 simply becomes part of the Taxable Income subject to the tax rates as indicated above, and the $1,000 in this case would be a deduction from Federal Tax payable.

- Partnerships
Partnerships never pay taxes. The tax returns for these entities report taxable income and identify the partners. Then, the partners are taxed on their pro-rata shares of the reported income, not the amount they actually receive.

Example: Three partners each own 33 1/3 % of a partnership that sells dog food. The partnership earns $1,000,000 and distributes $600,000 of the profits to the partners.

Each partner’s taxable income increases by $333,333. The partners are not taxed again on the cash payments when they are received.

- Trusts

Trusts are used for a variety of purposes. One is to provide professional investment management for gifts to better ensure the gift’s preservation. Trusts can sometimes fill a tax planning function by reducing taxable income.

In many cases, the beneficiary is taxed on part of the trust’s income. Thus, the beneficiary’s tax situation has some of the characteristics of the situation applicable to partners.

- Passive Activity Losses

For tax purposes, income and losses are divided into two categories:

- Non-passive (including salaries)
- Passive income (including such things as interest, royalties, dividends, capital gains)

Income is passive if the taxpayer doesn’t materially participate in the business. Limited partnership interests are always passive since limited partners do not assist in business management. The law specifies that rental activities are always passive.

Active and Passive income are generally calculated as specific schedules to the T1 General tax form and may have varying tax treatments.

- The Limited Partnership

Many investors prefer corporations to partnerships because corporate shareholders have limited liability. This means that, in most cases, shareholders can lose no more than their investments. In contrast, partnership investors do not have limited liability. Partners are often assessed for their share of partnership debts. If some partners are not able to contribute their shares, the remaining partners must contribute to make up the deficit.

Some partnerships are organized as limited partnerships. These partnerships have two categories of partners. One partner is a general partner. The general partner is responsible for all partnership debts.

Limited partnerships also have limited partners. These partners are never liable for partnership debts. Federal and Provincial laws usually prohibit limited partners from active roles in the management of the business. Thus, for tax purposes, losses by limited partners are always designated as passive.
TAX RETURNS AND CASH FLOW

Personal financial statements and customer interviews can provide valuable information concerning the customer’s assets, liabilities, and net worth. However, these documents provide only partial information concerning cash flow, the primary source of loan repayment.

Fortunately, you can learn to estimate personal cash flow through reference to tax returns. One advantage of this approach is that much of the information contained in tax returns is presented on the cash accounting basis. In addition, while some individuals may overstate their income on personal financial statements and credit applications, the overstatement of income on tax returns is less common. The cash flow estimation process is fast, and in most cases, is reasonably accurate.

For the most part, the tax return reflects only taxable or tax deductible items. Personal items not shown on the tax return include rent, meals, non-deductible education expenses, travel, vehicles, nondeductible taxes, and insurance – all included in “life style” expenses. These should be determined from the credit application or from interviews with the client. You can estimate personal items as a percentage of income and adjust this for apparent lifestyle. Cash is defined as unrestricted cash on hand, cash in the bank, and cash in money market accounts.

There are other items that may well affect cash and you need to understand them through discussions with your client. These include:

- Principal and interest payments on personal debt. As a general principle, unless interest expense is as a result of carrying charges or investment (refer Schedule 4 of the T1 General), it is not considered a deduction for tax purposes. Principal is never allowed as a taxable expense.

- Loans to others or the repayment of loans from others. Any interest income should be included as taxable investment income, but the principal payments would not be notated.

- Gifts to family members are not considered taxable, but certainly could have an effect on cash.

This section outlines a systematic approach to estimating cash flow, which entails proceeding through the tax return on a form-by-form basis. While this requires a basic understanding of the tax system and structure of the various forms, the estimation process does not require a tax expert. You should concentrate on the major items and ignore less likely possibilities. To estimate personal cash flow, we will consider the personal income tax schedules and forms, and we will also discuss the need to be aware of fraud, or irregularities that can occur in personal financial statements, tax returns and other financial data that you may receive in your analysis process.

Canada Revenue Agency Personal Income Tax Schedules and Forms   This discussion illustrates personal income tax forms, and you should be aware that these are subject to change by Canada Revenue Agency (CRA). For the most current form versions (and form numbering system), consult the CRA website at http://www.cra-arc.gc.ca.

In your analysis, you should consider the following parts of the personal tax return:

<table>
<thead>
<tr>
<th>Form</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>T1 General</td>
<td>Individual Income Tax Return</td>
</tr>
<tr>
<td>Form/Tax Schedule</td>
<td>Description</td>
</tr>
<tr>
<td>------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>T 4 Information Form</td>
<td>Wage and Tax Statement</td>
</tr>
<tr>
<td>Schedule 1</td>
<td>Federal tax calculation</td>
</tr>
<tr>
<td>Schedule 2</td>
<td>Federal Amounts Transferred from Spouse or Common-law Partner</td>
</tr>
<tr>
<td>Schedule 3</td>
<td>Capital Gains (or Losses)</td>
</tr>
<tr>
<td>Schedule 4</td>
<td>Statement of Investment Income</td>
</tr>
<tr>
<td>Schedule 5</td>
<td>Details of Dependent</td>
</tr>
<tr>
<td>Schedule 8</td>
<td>CPP Contributions on Self-Employment and Other Earnings</td>
</tr>
<tr>
<td>Schedule 9</td>
<td>Donations and Gifts</td>
</tr>
<tr>
<td>Schedule 11</td>
<td>Federal Tuition and Education Amounts</td>
</tr>
<tr>
<td>Form T5013</td>
<td>Limited or Non-Active Partner’s Share of Income, Etc.</td>
</tr>
<tr>
<td>Form T2124/T2032</td>
<td>Statement of Business or Professional Activities (self employment)</td>
</tr>
<tr>
<td>Form T2121</td>
<td>Statement of Fishing Activities</td>
</tr>
<tr>
<td>Form T2042</td>
<td>Statement of Farming Activities</td>
</tr>
<tr>
<td>Form T776</td>
<td>Statement of Real Estate Rentals</td>
</tr>
</tbody>
</table>
Form T1 General, Income Tax and Benefit Return

Form T1 General summarizes the tax return. It includes the calculation of tax payable.

Some of the more common T1 General items follow. In the discussion column we include those items that may not be cash payments and need to be considered when determining the cash available to your client. In addition, only those commonly used schedules and forms will be included for discussion.

<table>
<thead>
<tr>
<th>LINE NUMBER</th>
<th>DISCUSSION</th>
</tr>
</thead>
<tbody>
<tr>
<td>101 Employment income</td>
<td>These are assumed to be cash items.</td>
</tr>
<tr>
<td>113 Old Age security pension</td>
<td>Assumed to be cash.</td>
</tr>
<tr>
<td>114 CPP and QPP benefits</td>
<td>Assumed to be cash. Note that other lines on the T1 specific other forms of retirement benefits as well as RRSP payments which should also be considered to be cash.</td>
</tr>
<tr>
<td>119 Employment Insurance and other benefits</td>
<td>Assumed to be cash.</td>
</tr>
<tr>
<td>120 Taxable amount of dividends from taxable Canadian Corporations</td>
<td>Generally shown on T5, T4PS and T3 slips. Represents dividends received grossed up by 125%. The cash amount is prior to the gross up. This line also includes the client’s share of dividends earned by mutual funds, which are usually reinvested and not necessarily a source of cash.</td>
</tr>
<tr>
<td>Code</td>
<td>Description</td>
</tr>
<tr>
<td>------</td>
<td>-------------</td>
</tr>
<tr>
<td>121</td>
<td>Interest and other investment income</td>
</tr>
<tr>
<td>122</td>
<td>Net partnership income (loss)</td>
</tr>
<tr>
<td>126</td>
<td>Net rental income</td>
</tr>
<tr>
<td>127</td>
<td>Taxable capital gains</td>
</tr>
<tr>
<td>128</td>
<td>Support payments received</td>
</tr>
<tr>
<td>135 – 143</td>
<td>Self-employment income</td>
</tr>
<tr>
<td>207/208</td>
<td>Registered Pension Plan/RRSP deduction</td>
</tr>
<tr>
<td>212</td>
<td>Annual union, professional or like dues</td>
</tr>
<tr>
<td>214</td>
<td>Child care expenses</td>
</tr>
<tr>
<td>219</td>
<td>Moving expenses</td>
</tr>
<tr>
<td>220</td>
<td>Support payments made.</td>
</tr>
<tr>
<td>222</td>
<td>Deduction for CPP or QPP on self employment and other earnings</td>
</tr>
</tbody>
</table>
This represents the total paid for the year of the tax return, including Federal and Provincial or Territorial tax. Substantial overpayments or underpayments should be considered when developing predictions of future cash flow.

**Form T-4, Wage And Tax Statement**

Employees receive a T-4 form from each employer. This form shows the taxable wages and the withholding for federal and provincial/territorial taxes, as well as things like taxable benefits, CPP and UIC contributions, pension plan contributions, etc.

**Schedule 1, Calculation of Federal Tax**

Lines up to and including Line 8 are the calculation for basic federal tax, as used in the example at the beginning of this section. The rest of the form deals with Federal non-refundable tax credits as follows:

<table>
<thead>
<tr>
<th>LINE NUMBER</th>
<th>DISCUSSION</th>
</tr>
</thead>
<tbody>
<tr>
<td>300 Basic personal exemption</td>
<td>This is not cash items but serve only to reduce taxes payable</td>
</tr>
<tr>
<td>301 – 306 Exemptions for dependents/relations, etc.</td>
<td>Refer previous.</td>
</tr>
<tr>
<td>308/310 CPP or QPP contributions</td>
<td>This is a cash expense and subject to a maximum amount. It is detailed on the T4, or calculated on self-employment earnings on Schedule 8.</td>
</tr>
<tr>
<td>312 Employment insurance premiums</td>
<td>This is a cash expense and subject to a maximum amount.</td>
</tr>
<tr>
<td>319 Interest paid on student loans</td>
<td>Refer above.</td>
</tr>
<tr>
<td>323 Tuition and education amounts</td>
<td>Refer above. Details are calculated in Schedule 11.</td>
</tr>
<tr>
<td>330 Medical expenses</td>
<td>Medical expenses are cash items. When calculating cash flow, you must remember to utilize the total amount of medical expenses, not just the allowable portion.</td>
</tr>
<tr>
<td>349 Donations and gifts</td>
<td>Allowable deductions for donations and gifts is calculated on Schedule 9. Note that for cash flow purposes, the total amount of cash donated should be utilized rather than the allowable tax credit.</td>
</tr>
</tbody>
</table>
Schedule 3, Capital Gains (or Losses)

The tax return reveals the selling prices of nearly all property items sold, including stocks, bonds, farm property, real estate and other depreciable property, personal use property and listed personal property.

While the interest should be in the net cash inflow or outflow from investments, tax returns do not disclose replacement purchases of non-depreciable property. For this reason, you should discuss Schedule 3 disclosures with the client to determine net cash inflows from investments. Acquisitions of replacement investments should be verified to cover the possibility that clients have obtained cash only by liquidating investments. Brokerage statements provide verification for securities handled by brokers.

Schedule 4, Statement of Investment Income

<table>
<thead>
<tr>
<th>LINE NUMBER</th>
<th>DISCUSSION</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Taxable amount of dividends from taxable Canadian corporations. See the preceding discussion of the T1 General, line 120 concerning this item.</td>
</tr>
<tr>
<td>II</td>
<td>Interest and other investment income. See the preceding discussion of the T1 General, line 121 concerning this item.</td>
</tr>
<tr>
<td>III</td>
<td>Net partnership income (loss). See the preceding discussion of the T1 General, line 122 concerning this item.</td>
</tr>
<tr>
<td>IV</td>
<td>Carrying charges and interest expenses. These are cash items.</td>
</tr>
</tbody>
</table>

Other Schedules and Forms

In our earlier discussion of Personal Income Tax Schedules and Forms, we referred to several that we have not discussed in detail including:

- T5013 Limited or Non-Active Partner’s Share of Income, Etc.
- T2124/T2032 Statement of Business or Professional Activities (self employment)
- T2121 Statement of Fishing Activities
- T2042 Statement of Farming Activities
- Form T776 Statement of Real Estate Rentals

The process to determine the effect on cash flow to your client is the same as that we undertook for the T1 General form, and other Schedules we did discuss. The important thing to remember in this analysis is to ensure that you understand what are cash items and which are not, and that determination can be made by reference to the prior discussion.
FINANCIAL STATEMENTS AND INCOME TAX FRAUD

Look for irregularities in financial statements, income tax returns, and other related financial data you receive. For the most part, financial statement fraud occurs when borrowers paint themselves in the best light. They may overstate assets and income and understate liabilities and expenses. Corporations and partnerships also can commit fraud by increasing earnings per share.

Areas in which fraud/irregularities can be found are:

- Revenue recognition
- Revenue transfer from one period to another
- Asset valuation
- Off-balance-sheet transactions
- Treatment of sales
- Treatment of returns of sales
- Percentage of completion revenue
- Deferral of cost and expenses

Most fraud can only be detected by comparing financial statements and income tax returns over periods of time. Be sure your comparisons are between individual line items and that you are comparing dollars with dollars and percentages with percentages.

Prosecution for financial statement fraud can be found under the following statutes:

- The Criminal Code of Canada, which can levy fines or impose sanctions or jail terms.
- Securities Acts of the Jurisdictions, which can levy fines and impose sanctions.

In addition, professional organizations such as the CICA, which can impose sanctions against its members.

Income tax fraud is pursued by Canada Revenue Agency.
Dimension 4: Assess Strength and Quality of Client/Sponsor Cash Flow
Purpose of Dimension 4

The purpose of Dimension 4 is to review skills required to assess business cash flow. Key topics in this Dimension include:

- Cash Cycle Analysis
- Cash Flow Statement Analysis
- Cash Flow Methods
  - Direct
  - Indirect
- Alternative Cash Flow Measures
  - EBITDA or Earnings before interest, taxes, depreciation and amortization
  - Free Cash Flow
- Comparing Cash Flow to Industry Peers
- Discovering Borrowing Causes and Repayment Sources
- Developing Cash Flow Projections

Cash Cycle Analysis

The term cash cycle, sometimes called the asset conversion cycle, describes how cash moves through a business as its assets and liabilities shrink and expand in a fairly regular pattern. Cash typically moves to inventory, then to receivables, then back to cash. The amount of cash actually required to support the inventory portion of the cycle is reduced by the amount of trade credit available in accounts payable.

The flowchart below illustrates a simple cash cycle.
The duration and predictability of a company’s cash cycle affect its need for working capital. You can measure the average length of a company’s cash cycle by analyzing its days’ sales in receivables and days’ COGS in inventory and payables. These calculations and an explanation of them is provided in Dimension 3.

When a company has inadequate working capital (too little and not liquid enough) to get through a cash cycle, it will need to borrow. That borrowing will be long term if it is caused by a permanent lengthening of the cash cycle (declining efficiency) or by a permanent increase in the amount of cash needed daily (sales growth). The borrowing will be short term if it is caused by a temporary lengthening of the cash cycle or a temporary increase in the amount of cash needed daily.

Declining efficiency implies that either the receivable days on hand or COGS in inventory days on hand are increasing (or the total of the two, which is referred to as the operating cycle), or the payables days on hand has decreased.

Cash cycles vary with the type of business. For example, manufacturing companies that must invest in raw materials and work-in-process inventory as well as finished goods usually have a longer cash cycle than companies that are able to convert purchased merchandise inventory directly to accounts receivable. Companies that are able to convert inventory directly to cash, by selling for cash or accepting national credit cards, have a shorter cash cycle than companies that offer their customers extended payment terms.

**HOW TO MEASURE THE CASH CYCLE**

To measure a company’s average cash cycle, calculate average turnovers. Then add the average days’ sales in receivables to the average days’ COGS in inventory and subtract the average days’ COGS in payables.

\[
\text{AVERAGE DAYS’ SALES IN RECEIVABLES} + \text{AVERAGE DAYS’ COGS IN INVENTORY}
\]
-

- AVERAGE DAYS' COGS IN PAYABLES

= AVERAGE DAYS IN CASH CYCLE

Example: The turnover calculations for a wholesaler of abrasives products are: days' sales in receivables—107; days' COGS in inventory—76; and days' COGS in payables—72. Therefore, for this company it took an average of 183 days (107 + 76) for cash to move through inventory and receivables and back to cash. For 72 days of that period, on average, cash was provided by accounts payable. Therefore, the average cash cycle for this company was 111 days (183 – 72).

As a wholesaler, this company is a good example of the concept of adding and subtracting “days in” to calculate the cash cycle. When used on a manufacturer, purchases of raw materials are less than the full cost of goods sold and certainly less than sales. Thus, the subtracting and adding of days derived from these different items gives us only a rough idea of the cash cycle.

The wholesaler in our example is a relatively non-seasonal company, so using year-end balances for receivables, inventory, and payables is the best way to measure the average cash cycle. But remember that the calculation is an average, and even a non-seasonal company will experience actual cycles that are longer or shorter than the average during a year. When working capital is just adequate to support average cycles, a slightly longer cycle—created, for example, by a large receivable being just a few days late—can create a borrowing need.

**BENEFITS OF CASH CYCLE ANALYSIS**

Measuring the cash cycle helps you analyze the adequacy of a company's working capital and evaluate if it may need to be permanently increased with a long-term loan (or an equity injection from the owners) or temporarily supplemented with a short-term loan. In addition, the cash cycle concept helps you distinguish three reasons why cash can become available for loan repayment:

1. Because it is temporarily freed up in the cash cycle.
   
   This source of repayment depends only on the company’s ability to turn cash into inventory, receivables, and back to cash without incurring losses. No new cash, such as from profits retained, needs to be injected.

   **Example:** Cash can be available temporarily when a large receivable pays early or when management decides to defer payment to trade creditors for a few days to allocate cash to other needs. Cash also can be available on a temporary but regular and fairly predictable basis when a business has seasonality.

2. Because the cash cycle becomes permanently shorter or requires less cash when sales have a permanent decline.

   This is another way to express permanent improvement in current asset and working capital efficiency, permanent increases in trade credit terms, or lower asset requirements as a result of lower sales.

   **Example:** Cash becomes available for loan repayment on a relatively permanent basis when the cash cycle shortens and does not need to extend again. Also, cash becomes available when sales decline so that each average day’s sales and COGS are less, provided the company
does not incur losses that absorb any cash released from the cash cycle.

3. Because profit is generated and retained and the cash cycle is not expanded to absorb it.

Unlike the first two sources of repayment (from cash already available within the cash cycle), profits (adjusted for non-cash expenses, such as depreciation) introduce net new cash into a company.

LIMITATIONS OF CASH CYCLE ANALYSIS
Cash cycle analysis has two limitations:

1. All cash cycle calculations are averages, which can:
   • Mask irregularities that are inevitable for all companies.
   • Mislead you when analyzing seasonal companies.

   To compensate for this limitation, you should realize that every company will experience actual cycles that are longer and shorter than the calculated average. For seasonal companies, you must distinguish between a company’s shortest cash cycle, or period of lowest daily sales with a base level of cash need, and its longest cash cycle, or period of highest daily sales with a seasonally high level of cash need.

2. The cash cycle calculation excludes cash requirements for payments other than cost of goods sold.

   Most companies periodically make other sizable cash payments for dividends, taxes, and selling expenses. The most precise way to estimate all those cash needs is to prepare a cash receipts and disbursements budget.

VARIATIONS IN CASH CYCLE BY TYPE OF BUSINESS
Businesses that must make a substantial investment in current assets to produce goods or services have a longer cash cycle and need more working capital than do businesses that require little investment in current assets.

Example: Hotels, restaurants, airlines, and utilities all generate revenues without substantial investments in inventories (in relation to their other assets). They also have minimal cash tied up in accounts receivable since they sell mostly for cash, use national credit cards, and have short-term billing. Consequently, they have relatively short cash cycles and little need for working capital. Many companies in those industries have negative working capital.

The opposite is true of most manufacturing companies and wholesalers, which depend on turning inventory to generate sales and which usually have to offer their customers payment terms. These companies have longer cash cycles and cannot operate successfully with negative working capital.

Here are some calculations of average cash cycles taken from the all-sample median of industry composites in a recent RMA Annual Statement Studies:

<p>| Days Outstanding |</p>
<table>
<thead>
<tr>
<th>Industry</th>
<th>NAICS</th>
<th>A/R</th>
<th>Inventory</th>
<th>A/P</th>
<th>Cash Cycle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restaurants</td>
<td>71111</td>
<td>1</td>
<td>+13</td>
<td>-25</td>
<td>-11</td>
</tr>
<tr>
<td>Airlines</td>
<td>481111</td>
<td>30</td>
<td>N/A</td>
<td>-N/A</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>481112</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hotels</td>
<td>72111,</td>
<td>30</td>
<td>N/A</td>
<td>-N/A</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>72112</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supermarkets</td>
<td>445111</td>
<td>1</td>
<td>+23</td>
<td>-13</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>44512</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturers (Computers)</td>
<td>334111</td>
<td>69</td>
<td>+99</td>
<td>-45</td>
<td>123</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesalers (Computers)</td>
<td>42143</td>
<td>36</td>
<td>+57</td>
<td>-38</td>
<td>55</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retails (Computers)</td>
<td>44312</td>
<td>34</td>
<td>+59</td>
<td>-32</td>
<td>61</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Computer Processing</td>
<td>51421</td>
<td>+51</td>
<td>+N/A</td>
<td>-N/A</td>
<td>51</td>
</tr>
</tbody>
</table>

Among those industry examples, restaurants have the shortest cash cycle and therefore the smallest need for working capital. The longest cash cycle in those examples, 123 days, belongs to manufacturers of computers because they require a lengthy investment in manufacturing inventory and must also offer terms to their customers (distributors, wholesalers, or retailers of their products).

Note: Airlines, hotels, and computer processing sources have no inventory and accounts payable. Therefore those calculations are not applicable to their cash cycles.

**Net Working Capital Concepts**

Net working capital is defined as current assets less current liabilities.

CURRENT ASSETS - CURRENT LIABILITIES = NET WORKING CAPITAL

When an increase in current assets is supported by an equal increase in current liabilities, there is no change in net working capital. If a reduction in current liabilities is accomplished by an equal reduction in current assets, there is no change in net working capital.

The two ways to increase working capital are 1) to support an increase in current assets with something other than an increase in current liabilities and 2) to finance a decrease in current liabilities with something other than a reduction of current assets.

To increase working capital, a company must:

- Increase current assets through an increase in long term debt or net worth.
- Decrease current liabilities through an increase long-term debt or net worth.
- Increase long-term liabilities or net worth with the cash utilized to repay current liabilities or invest in current assets.
• Decrease long-term assets with the funds generated utilized to repay current liabilities or invest in current assets.

To decrease working capital, a company can:

• Decrease current assets with the use of funds either to increase long-term assets or decrease long-term liabilities.

• Increase current liabilities with the funds being utilized to purchase long-term assets or repay long-term debt.

• Decrease long-term liabilities or net worth with the source of funds being either current assets (i.e. a decrease in cash) or current liabilities (i.e. an increase in a short-term liability).

• Increase long-term assets by decreasing current assets or increasing short-term liabilities.

Examples of transactions that do or do not affect net working capital include:

• If a company collects accounts receivable and uses the cash to pay a current liability, there is no change in working capital.

• If a company collects accounts receivable and uses the cash to pay down long-term debt, purchase fixed assets, or pay dividends, working capital decreases.

• If a company increases net worth or long-term debt and uses the proceeds to support higher levels of inventory, working capital increases.

• If the proceeds of increases in net worth or long-term debt are used to acquire fixed assets, working capital is unchanged.

Working capital is a quantitative measure of liquidity, but its weakness as an analytic tool is that its existence is not proof of convertibility to cash in that it provides no measure of qualitative analysis. A company with low net working capital but with a healthy cash position and inventory and receivables turning over regularly is more liquid than a company with high net working capital but illiquid current assets.

As an example, a company has a large amount of working capital, but its current assets consist entirely of unsaleable inventory and uncollectible receivables. Therefore, it does not have cash available to pay current liabilities as they become due.

If two companies of the same size have assets of equal quality and equally stable current liabilities, the one that has higher net working capital (or a lower net sales-to-net working capital ratio) provides lenders a greater margin of protection in liquidity. That logic often leads analysts to the false conclusion that an increase in net working capital is always a sign of improved creditworthiness and that a decrease in net working capital always weakens creditworthiness.

When analyzing working capital, you must keep in mind these two concepts:

1. An increase in the non-cash portions of working capital is a use of cash. If the company cannot at least temporarily get the cash back out of working capital (by collecting receivables or selling inventory), the added quantity of working capital has not improved liquidity.

   **Example:** Consider a situation where net working capital has grown because receivables or inventory have increased based on a decline in turnover. If the resulting increase in current assets is supported by increases in long-term debt or net worth or by decreases in long-term assets liquidity has not improved because the new working capital cannot be reconverted to cash unless current asset turnover improves (shortening the cash cycle).

2. The liquidity of current assets, measured by asset quality and receivables and inventory turnover, is a key factor in how much working capital a company needs. The higher the
quality and the more rapid the turnover (the closer current assets are to cash), the less working capital a company needs.

Example: Compare Company A which has a high percentage of current assets in cash and accounts receivable (a high quick ratio and low reliance on inventory to cover current liabilities) with Company B that has little cash on hand and has low receivables. Company A needs less of a working capital cushion to be sure of having cash available to meet current liabilities than does Company B as Company B must convert inventory to cash to pay its current obligations.

**IMPACT OF SEASONALITY ON THE CASH CYCLE**

Many businesses have seasonal variations in sales, inventory accumulation, receivables collection, or disbursements. To measure those variations, you must analyze interim financial statements that report on financial condition and performance monthly or quarterly during the fiscal year. By analyzing interim statements, you can determine the cash effects of seasonality and distinguish between permanent base levels of assets and liabilities and temporary levels caused by seasonality. That way, you can estimate whether outstanding loans can be repaid in the short term and whether seasonal borrowing will be needed in the future.

Seasonality can alter cash requirements in two ways:

1. By temporarily lengthening the cash cycle.
2. By increasing daily average sales or cost of goods sold (COGS).

You might encounter these seasonal business patterns that can cause seasonal borrowing:

- Seasonal sales that increase daily average sales or cost of sales and sometimes cause a mismatch of cash receipts and disbursements.
- Level sales and cash receipts but uneven seasonal cash disbursements that lengthen the cash cycle.
- Level sales and cash disbursements but uneven seasonal cash receipts that lengthen the cash cycle.

**SEASONAL SALES**

Seasonality of sales, an increase in daily average sales, is the most common and most obvious seasonal business pattern. It increases cash requirements and can cause a need to borrow even when there is no change in the length of the cash cycle. Seasonal sales are usually preceded by a period of inventory buildup and are usually accompanied and followed by a period of higher receivables. In such a pattern, the company’s seasonal need for additional cash begins with the inventory buildup and lasts until the receivables have dropped back to lower levels. During that period of seasonal cash needs, average daily sales increase and if receivables or inventory grow faster than sales (such as during inventory buildup), the cash cycle lengthens.

Recognizing inventory as a significant use of cash, many businesses try to reduce the length of time they must carry it. Before buying, they encourage their suppliers to hold materials and merchandise for as long as possible, and they look for suppliers who offer quick turnaround between orders and delivery. This practice of strict inventory management—in effect, getting suppliers to carry some of their customers’ inventory burden—has been called “just in time” inventory, or production management.
Manufacturers with seasonal sales can respond with their own inventory management strategies, keeping levels of raw materials as low as possible. But each also must select a production strategy, and that strategy will affect levels of work-in-process and finished goods inventory and seasonal borrowing requirements.

Manufacturers can use either level production or peak period strategies, or a combination of the two, to prepare for seasonal sales.

**Level Production**

Companies engaging in level production produce a consistent amount each period and gradually build up the finished goods they will need for their peak sales.

Cash disbursements for production costs are spread out evenly throughout the year, but cash required to support inventory builds when production exceeds sales.

**Peak Period Production**

During their season or immediately before it, companies engaging in peak period production produce all the goods needed for peak sales by working overtime, adding a second or third shift, or subcontracting peak orders to other manufacturers.

Inventory buildup and borrowing requirements occur much closer to the peak sales and tend to overlap the period of receivables buildup. Therefore, borrowings may not last as long, but may reach higher levels than if the company used level production.

**Seasonal Cash Disbursements**

The second seasonal business pattern that often causes seasonal borrowing is cash disbursements that are not level throughout the year, even when sales are level. Remember that expenses may be accrued evenly during the year, but cash payments may be uneven.

Examples of cash disbursements that may not be level throughout the year include:

- Dividends.
- Estimated or final tax payments.
- Bonuses.
- Expenditures for an annual catalog.

**Seasonal Cash Receipts**

The third and least common seasonal business pattern that contributes to seasonal borrowing is uneven cash receipts despite fairly level sales. This situation occurs in some businesses when it is customary to allow customers to have special payment terms based on their seasonal ability to pay (often described as “dating of receivables”). Such companies might need to borrow to carry the higher receivables they will have as a result of offering extended terms to their customers.

Situations in which receipts might not be level throughout the year include the following:

- Suppliers to farmers may sell throughout planting and growing seasons, but are not paid until farmers harvest and sell the crops.
• Suppliers to government agencies may sell throughout the year, but are paid as the agency receives funding allocations.
• Suppliers to educational institutions may sell throughout the term, but are paid when students pay tuition.

**DISTINGUISHING BETWEEN SEASONAL AND BASE-LEVEL ASSETS**

Current assets are either permanent or temporary.

• A permanent base level of current assets, such as receivables and inventory, is required to support the relatively low level of sales that occurs during non-peak periods. That base level of current assets is just as permanent as, although more liquid than, a company’s investment in fixed assets, such as plant and equipment.

• A temporary, incremental level of receivables or inventory is required to support the higher level of sales that occurs during peak periods. Only that incremental level of current assets is temporary or seasonal; the base level of current assets is permanent.

The graph that follows depicts incremental current assets building up in addition to permanent current assets and fixed assets for a manufacturer of submersible pumps used in decorative fountains, waterfalls, and birdbaths. When you look at the graph, take note of the following:

• The company begins its fiscal year in November with no seasonal assets; total assets are approximately $200,000.

• By May, incremental assets needed for seasonal sales have increased total assets to almost $300,000 (probably inventory increased in February and March and has begun to subside by May as receivables are increasing rapidly with seasonal sales).

• By the fiscal year-end at October 31, incremental assets have been liquidated (inventory sold and receivables collected), and the company has shrunk back to its low point of base-level assets.
This concept of seasonal and base-level assets is significant because:

- Permanent base-level current assets should be supported by net worth or long-term debt. If they are supported by current liabilities, those current liabilities cannot be reduced through asset conversion.

- Only the temporary seasonal assets will liquidate and provide cash to repay loans.

Failure to recognize base-level assets can often result in “locked in” operating loans, or those that do not reduce to zero at least once during the operating cycle.

The graph below depicts a liability structure that is appropriate to support the pump manufacturer’s base-level and seasonal asset requirements: Temporary current debt supports temporary current assets.

As you study the graph, notice the following:

- Only the temporary current debt (which is truly seasonal) will be repaid from shrinking assets down from seasonal to base levels.

- The permanent current debt, such as revolving bank loans, and such long-term debt as term loans with scheduled payments, will be repaid only from profits and cash benefits of depreciation and other noncash charges.
Seasonal and Permanent Liabilities

(Total Liabilities & Equity $000s)

<table>
<thead>
<tr>
<th></th>
<th>November</th>
<th>April/May</th>
<th>October</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Current</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Permanent</td>
<td>+100</td>
<td>+100</td>
<td>+100</td>
</tr>
<tr>
<td>Current</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt or LTD</td>
<td>200</td>
<td>300</td>
<td>200</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>TOTAL LIABILITIES AND EQUITY</td>
</tr>
</tbody>
</table>

To quantify the amount of temporary current assets that you can expect to shrink and repay temporary current liabilities, compare receivables and inventory balances on interim and year-end statements. The difference between the low and high points of combined receivables and inventory is the temporary current asset requirement, the amount that can be soundly supported by temporary current liabilities.

**Example:** Company A’s quarterly interim financial statements illustrate temporary asset and liability patterns similar to those in the preceding graphs.

<table>
<thead>
<tr>
<th></th>
<th>9/30/X0</th>
<th>12/31/X0</th>
<th>3/31/X1</th>
<th>6/30/X1</th>
<th>9/30/X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>495</td>
<td>434</td>
<td>263</td>
<td>1,717</td>
<td>522</td>
</tr>
<tr>
<td>Inventory</td>
<td>1,120</td>
<td>1,333</td>
<td>1,756</td>
<td>1,085</td>
<td>1,302</td>
</tr>
<tr>
<td>Total</td>
<td>1,615</td>
<td>1,767</td>
<td>2,019</td>
<td>2,802</td>
<td>1,824</td>
</tr>
</tbody>
</table>

Peak temporary current assets of $2,802,000 occur at 6/30/X1; by 9/30/X1 assets have shrunk to their base level of $1,824,000. Company A could repay $978,000 in temporary current liabilities through asset conversion (inventory and receivables converted to cash).

It is possible that combined receivables and inventory peaked earlier in the quarter ended 6/30/X1 and had started shrinking by quarter-end, or they continued to rise until sometime in the fourth quarter and then fell to the low level by 9/30/X1. If you cannot obtain monthly statements, which many companies do not prepare because they can be time consuming and expensive, confirm the actual peak with management.

Notice that the lowest level of combined receivables and inventory in Fiscal Year X1 actually occurred at 12/31/X0. However, since that amount was higher than the balance at the preceding fiscal year-end, we do not believe it is the low point. Instead it reflects an increase in the base level of current assets as a result of either sales growth or declining efficiency.
In other words, Company A experienced an increase in combined receivables and inventory equal to $1,187,000 ($2,802,000 - $1,615,000) but was able to repay only $978,000 ($2,802,000 - $1,824,000) from shrinkage of seasonal assets back to base levels. The rest, $209,000 ($1,187,000 - $978,000), has become a part of base-level assets and could be repaid only from profits.

When sales are increasing annually as well as seasonally, or when the cash cycle is lengthening owing to permanent as well as seasonal declines in receivables or inventory turnover, the distinction between temporary and base-level assets is more difficult to see. It is important to isolate them so that you can properly assess the borrowing cause and repayment source and therefore the loan’s risk and realistic maturity.

When increases occur both in temporary current assets and in permanent base-level assets, it may help you to think of the pattern in the graph below. The permanent increase in base-level assets may be the result of sales growth or declining efficiency.

### Seasonality and Growth Base-Level Assets

<table>
<thead>
<tr>
<th>(Total Assets $000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>300</td>
</tr>
<tr>
<td>200</td>
</tr>
<tr>
<td>100</td>
</tr>
</tbody>
</table>

- **Temporary Current Assets**
- **Permanent Current Assets**
- **Fixed Assets**

(N D J F M A M J A S O (Months))

### Cash Flow Statement Analysis

Cash repays debt. The income statement and beginning and ending balance sheets for a period provide the information necessary to calculate cash flow.

In cash flow analysis you need to:

- Distinguish between profit and cash flow
- Understand the three categories of cash flow
  - Operating
  - Investing
  - Financing
- Recognize the benefits and limitations of the statement of cash flow
- Analyze the quality of the cash flow
- Identify operating and extraordinary demands on cash flow
- Isolate historical cash flow available for debt service
• Project cash flows that will be available for future debt service

CASH FLOW STATEMENT FORMATS

You must determine how the statement of cash flow assists in reconciling the results of a company’s financial performance for a year to the change in cash from beginning to end of the year.

There are different methods of calculating or measuring cash flow. Each financial institution has its preferred method of analyzing and presenting cash flow. Some institutions use the direct method and some use the indirect method, yet others use a hybrid method developed for their particular purposes. Short-term lenders may favor the direct method of cash flow analysis while long-term lenders may prefer the indirect method.

The CICA Handbook, under Section 1540, allows either the direct or indirect method. Regardless of the method, the primary purpose of cash flow analysis is to provide managers, investors, lenders and other interested constituents with additional information about the financial health of a company. When the accounting profession issues an Audit, it usually includes the indirect cash flow in the financial statements. You are able to construct the direct cash flow statement when the income statement and balance sheet are spread utilizing one of the software packages available in the market today.

Topics included in this discussion are:

• Direct Versus Indirect Cash Flow

• Cash Flow Terminology for the Direct Method

• Analyzing Cash Flow

• Cash Flow Ratio Analysis

DIRECT VS INDIRECT CASH FLOW

What are the differences between direct and indirect cash flow?

Direct cash flow is known as the “top down” approach, while the indirect cash flow is known as the “bottom up” approach.

• The starting points are different. Direct cash flow starts with the “top line” on the income statement (Net Sales) whereas the indirect cash flow starts with the “bottom” line on the income statement (Net Income).

• Direct cash flow starts with the income statement (Net Sales) and methodically adjusts the corresponding balance sheet accounts (sometimes referred to as the “buddy accounts”) to highlight which changes in the working capital assets are affecting the cash flow generated from operations.

• Direct cash flow breaks out interest expense. Interest expense in the indirect cash flow is included in the net income figure, so you can’t tell how comfortably the company can pay its interest.

• CPLTD (Current Portion Long Term Debt) is broken out as a claim against the operating cash flows of a company in the direct method. The indirect method combines CPLTD
with other changes in long-term debt to arrive at a “net” number for an increase or
decrease in long-term debt. It is not as easy to determine from the indirect method how
maturing long-term debt has been financed, either from new long-term debt or from
operating cash flow.

- The direct cash flow statement does not include net income, and, as a result, it is harder
to determine the sustainable profitability and, ultimately, the long-term debt-service
capacity of your customer.

Both methods of presenting cash flow facilitate the analysis of the internally generated
sources of cash flow that are available to service debt.

The primary purpose of the cash flow is to provide the many different interested parties with
information about the financial performance of a business. Your analysis should focus on
how a company is positioned to handle its institutional debt relationship:

- Can it pay interest?
- Can it pay CPLTD?
- How much external financing does the company require?
- How have these external financing needs been met?

Cash flow analysis, also provides answers to the following four basic questions:

- Is cash flow from operations sufficient to pay interest on all debt?
- Is cash flow from operations sufficient to repay scheduled maturities of LTD (Long Term
  Debt)?
- What are the company’s financing requirements (or financing surplus) after capital
  expenditures and other long-term investments?
- How has the company financed it activities? Is it through additional debt or equity, or the
draw-down of cash balances?

The cash flow statement provides a picture of the company’s functions broken down by
current (operating activities) and long-term (investing activities) requirements, and the
funding (financing activities) necessary.

**Basic Cash Flow Concepts**

The sources or inflows of cash are from:

- Revenues
- Decreases in assets
- Increases in liabilities
- Increase in equity

The uses or outflows of cash are from:
• Expenses
• Increases in assets
• Decreases in liabilities
• Decrease in equity

It is only by understanding the underlying reason for the change in these categories that the true effect on cash flow can be determined.

For funding purposes, the primary sources of cash for operating and investing activities will be:

• Cash from operations.
• Cash from external financing (either debt or equity).
• Drawing down on existing cash balances.
DIRECT AND INDIRECT CASH FLOW STATEMENT FORMATS
The following exhibits illustrate the direct and indirect cash flow statement formats.

Direct Cash Flow Statement
The following is an example of a direct cash flow statement worksheet:

CASH FLOW WORKSHEET (PAGE 1 OF 2)

1. Net Sales Revenue - Y2*  
2. Accounts Receivable - Y1  
3. Accounts Receivable - Y2  
4. CASH FROM SALES  
5. Cost of Goods Sold - Y2  
6. Depreciation in Cost of Goods Sold (if any)  
7. Inventory - Y1  
8. Inventory - Y2  
9. Accounts Payable - Y1  
10. Accounts Payable - Y2  
11. Other Accounts Payable - Y1  
12. Other Accounts Payable - Y2  
13. CASH PRODUCTION COSTS  
14. GROSS CASH PROFITS  
15. Operating Expenses (SG&A) - Y2  
16. Depreciation and/or Amortization in SG&A (if any)  
17. Prepaids - Y1  
18. Prepaids - Y2  
19. Accruals - Y1  
20. Accruals - Y2  
21. CASH OPERATING EXPENSES  
22. CASH AFTER OPERATIONS (+/-)  
23. Miscellaneous Income  
24. Miscellaneous Expense  
25. Other Current Assets - Y1  
26. Other Current Assets - Y2  
27. Other Current Liabilities - Y1  
28. Other Current Liabilities - Y2  
29. Other Noncurrent Assets - Y1  
30. Other Noncurrent Assets - Y2  
31. Other Noncurrent Liabilities - Y1  
32. Other Noncurrent Liabilities - Y2  
33. TOTAL MISCELLANEOUS (+/-)  
34. Tax Provision - Y2  
35. or Tax Benefit - Y2  
36. Taxes Payable - Y1  
37. Taxes Payable - Y2  
38. Deferred Taxes - Y1  
39. Deferred Taxes - Y2  
40. Tax Refunds Due - Y1  
41. Tax Refunds Due - Y2  
42. CASH TAXES PAID (+/-)  
43. NET CASH AFTER OPERATIONS (+/-)  
44. Interest Expense - Y2  
45. Interest Payable - Y1  
46. Interest Payable - Y2  
47. Dividends - Y2  
48. Dividends Payable - Y1  
49. Dividends Payable - Y2  
50. FINANCING COSTS  
51. NET CASH INCOME (+/-)

*Y2 is the year for which the cash flow is being constructed; Y1 is the previous year.
**CASH FLOW WORKSHEET ** (PAGE 2 OF 2)

51. **NET CASH INCOME (+/-)**

52. Current Maturities Long-Term Debt - Y1

53. Current Maturities Capital Lease Obligations - Y1

54. **TOTAL DEBT AMORTIZATION**

55. **CASH AFTER DEBT AMORTIZATION (+/-)**

56. Net Fixed Assets - Y2

57. Net Fixed Assets - Y1

58. Change in Net Fixed Assets (+/-)

59. Depreciation - Y2

60. **CAPITAL EXPENDITURES**

61. Intangibles - Y1

62. Intangibles - Y2

63. Investments - Y1

64. Investments - Y2

65. **TOTAL LONG-TERM INVESTMENTS (+/-)**

66. **FINANCING SURPLUS/REQUIREMENT**

67. Short-Term Debt - Y1

68. Short-Term Debt - Y2

69. Change in Short-Term Debt (+/-)

70. Current Maturities Long-Term Debt - Y2

71. Long-Term Maturities Long-Term Debt - Y2

72. Total Long-Term Debt - Y2

73. Long-Term Maturities Long-Term Debt - Y1

74. Change in Long-Term Debt (+/-)

75. Subordinated Debt - Y1

76. Subordinated Debt - Y2

77. Change in Subordinated Debt Obligations (+/-)

78. Equity - Y1***

79. Equity - Y2***

80. Change in Equity *** (+/-)

81. **TOTAL EXTERNAL FINANCING (+/-)**

82. **CALCULATED CHANGE IN CASH (+/-)**

83. **ACTUAL CHANGE IN CASH (+/-)**

** Write results of column 1 calculations in column 2, and results of column 2 in column 3.

***Reflect only the change in common stock, NOT retained earnings.
**Indirect Cash Flow Statement**

The following is an example of an indirect cash flow statement worksheet:

1. Net Income (after tax)
2. Plus: Depreciation & Amortization
   Income Statement Cash Flow
3. Accounts Receivable–Decr. (Incr.)
4. Inventory–Decr. (Incr.)
5. Miscellaneous Current Assets–Decr. (Incr.)
6. Accounts Payable–Incr. (Decr.)
7. Accrued Expenses–Incr. (Decr.)
8. Income Tax Payable & Deferred Tax–Incr. (Decr.)
9. Other Current Liabilities–Incr. (Decr.)
10. Other Noncurrent Liabilities–Incr. (Decr.)

**OPERATING CASH FLOW**
11. Marketable Securities–Decr. (Incr.)
12. Long-term Investment–Decr. (Incr.)
14. Nonrecurring Gain (Loss)
15. Intangible & Other Noncurrent Assets–Decr. (Incr.)

**INVESTING CASH FLOW**
   Cash Flow before Financing
16. Short-term Debt–Incr. (Decr.)
17. Long-term Debt–Incr. (Decr.)
18. Subordinated Debt–Incr. (Decr.)
   Debt Financing Cash Flow
19. Capital Stock–Incr. (Decr.)
20. Dividends Paid
21. Adjustments to Retained Earnings
22. Minority Interest–Incr. (Decr.)
   Equity Financing Cash Flow
23. Beginning Cash
24. Operating Cash Flow
25. Investing Cash Flow
26. Financing Cash Flow
   COMPREHENSIVE CASH FLOW
27. ENDING CASH

**Cash Flow Terminology - Direct Method**

The indirect cash flow is generally provided in the Auditor’s financial reports and is self-explanatory.

The direct cash flow must be constructed and the resulting presentation requires further explanation. If you choose to use the direct cash flow method in your analysis, the following terms will be helpful:

- **Cash from Sales**

  That portion of the present year’s sales collected in the present year, plus any amounts from previous years’ sales collected during the present year.
• Cash Production Costs

Cash expended during the present year to produce goods for sale (manufacturer) or to acquire merchandise (wholesaler or retailer). In the case of a manufacturing company, this figure may be adjusted for depreciation as well as for changes in inventory, accounts payable, and other payables.

• Gross Cash Profit

The difference between cash from sales and cash production costs.

• Cash Operating Expenses

Actual cash spent during the present year for selling, general, and administrative expenses. SG&A will be adjusted for depreciation as well as for changes in prepaid and accrued expenses.

• Cash after Operations

Computed by subtracting cash operating expenses from gross cash profit.

• Net Cash after Operations

Cash remaining after adjusting cash after operations to reflect net cash outlays (or inflows) arising from changes in income taxes and in miscellaneous assets and liabilities. It is the amount of cash available for servicing interest on bank debt. Investigate large miscellaneous sources and uses of funds.

• Net Cash Income

Computed by deducting financing costs (interest, dividends, or withdrawals) from net cash after operations. Remember to include in total interest costs the amount of interest that was calculated according to GAAP.

• Cash after Debt Amortization (CADA)

Computed by subtracting the current maturities of term debt outstanding, or the scheduled amortization of demand loans (as discussed in Dimension 3) at the end of the previous year from net cash income. If, after this deduction, there is still a positive figure, it could mean that a company has been able to generate sufficient cash from its internal operations to meet all its current obligations to its debt holders, including interest and principal payments on your institution’s debt. If the figure is negative, your customer must resort to external sources of financing to meet these obligations and make any capital expenditures.

• Financing Requirements or Surplus

Computed by subtracting fixed-asset purchases and expenditures for long-term investments from cash after debt amortization. This measures either the magnitude of external financing needed or the cash generated in excess of all needs of the business.

• Calculated Change in Cash
“External financing” refers to the provision of additional cash to a company from new debt or equity. This entry will result in an excess or shortfall of cash after adjusting the financing requirement or surplus by the amount of any external financing.

- Actual Change in Cash

This represents the change in the cash account on the balance sheet from the preceding year’s to that of the current year. The change in cash includes changes in other cash equivalent accounts, such as marketable securities classified as current assets.

**Analyzing Cash Flow**

Whether using the direct or indirect methods, the overall approach to measuring cash flows is to:

- adjust accrual revenues and expenses to a cash basis by measuring changes in related balance sheet accounts and determining whether each balance sheet change was a source or a use of cash.

- eliminate non-cash expenses, such as depreciation and amortization, from operating activities in determining cash flow from operations.

- combine depreciation and amortization with changes in noncurrent assets, and measure their effect on investing activities.

- measure changes in short and long-term debt and paid-in equity to determine their effect on financing activities.

Once you have constructed a cash flow statement (or prepared one using an automated financial statement spreading program), the most important cash flow analytical step is to use the statement to assess the quality of the customer’s cash flow.

**Cash Flow Quality**

Cash flow quality depends on the source and repeatability of the cash flow. Cash flow sources important to you are:

- Those that are sustainable and reasonably predictable over the ensuing three to five years.

- Those that increase your margin of protection and indicate your customer’s economic viability.

Analyzing cash flow means determining if there are sufficient high-quality and continuous sources of funds to meet all the financial demands placed on the cash flow, while still leaving enough cash to repay your customer’s obligations. Your customer can have positive cash flows but be in a declining financial condition—a scenario that does not bode well for debt repayment over the long-term. The opposite is also true, in that a growing company can have negative cash flow but exhibit profitable operations. In this case, you need to understand the nature of the growth and assure yourself that management has control of the expanding business. If a company is too successful, it can put strains on the banking relationship by requiring large amounts of external financing.
Assessing Quality of Cash Flow

- The most desirable cash flows are those from authentic and repeatable revenues and related non-cash expenses. They are the cash flows that improve margins of protection because they are repeatable and they are the result of the company’s economic earning power.

- The second most desirable sources are improvements in asset efficiency and the proceeds of additional equity. Improved efficiency might not be repeatable, but it is a sign of good management and enables the company to improve its return on assets while maintaining the same profit margins. The proceeds from additional equity are not usually a predictable recurring source of cash.

- The least desirable sources are flows from additional debt or from the sale of assets. Additional debt, while it may have benefits for your customer, increases leverage, can reduce profitability by adding to the interest burden, and can reduce liquidity by adding to annual principal debt service (all of which weaken your margin of protection). Sale of an asset may also have immediate onetime benefits, but if it is an operational asset, it can reduce the future earning power of your customer.

To analyze the demands on cash flow you should:

- Look carefully at the statement of cash flows and identify the negative flows within each category.

- Consider whether each negative cash flow is a one-time, irregular event or if it is likely to be recurring.

- Consider if the amount of each negative cash flow is typical for that transaction or if it is unusually low or high.

- Decide if the event or transaction producing the negative cash flow is within the control of management.

- Compare historical demands with historical sources, and expected future demands with expected future sources.

In both the direct and indirect cash flow formats, analyze operating and investing activities and the effect of the resulting surplus or deficit on financing activities. There are three levels of analysis:

- Analyzing Operating Cash Flows

- Analyzing Investing Cash Flows

- Analyzing Financing Cash Flows

Analyzing Operating Cash Flow

When using an indirect method cash flow statement, focus on the Operating Cash Flow section of the statement. If you are working with a direct method cash flow statement, focus your analysis on the portion of the statement that ends with Net Cash After Operations. Using either method, it is important to distinguish between the two types of cash flows included in this category: earnings and cash cycles. Cash flow derived from earnings is dependent on business fundamentals, whereas the cash cycle is driven by swing factors. By
business fundamentals, we mean management of the company’s gross profit and its operating expenses. By swing factors, we mean management of the company’s trading accounts—accounts receivable, inventory and accounts payable.

- Positive operating cash flow can be attributable to strong fundamentals. A company that generates sustained gross profit and succeeds at controlling its operating expenses has not only strong accrual profit in each sale dollar, but also great potential for cash profits.

- Changes in the swing factors reflect a company’s ability to manage its working capital assets, and these changes can have a significant influence on cash flow. For example, growth in accounts receivable and inventory consume company cash, but growth in accounts payable is a source of cash.

Keep in mind that the cash benefits of strong fundamentals can be erased by poor management of the swing factors. Conversely, if there is a temporary strain on fundamentals—perhaps a year in which a company decided to buy its way into a new market through aggressive price competition—astute management of the swing factors can help compensate for the cash flow lost to poor margins. Whenever the combination of fundamentals and swing factors produces positive operating cash flow, there is an added margin of protection for you.

Carefully consider the components of operating cash flow to form your opinion of the quality and sustainability of cash flow. Cash from continued operating activities is higher quality than cash from discontinued operations. Cash from the sale of operating assets is generally neither predictable nor repeatable, so is of lesser quality than cash from operating activities. In addition, you need to consider what affect on future cash flow that the sale of assets might have. A key entry to look at is the magnitude of the miscellaneous income/(expense), as this category reflects nonoperating cash flows and is suspect in terms of sustainability.

If you are analyzing a Uniform Credit Analysis (UCA) direct method cash flow statement, you have the additional benefit of being able to determine whether debt service (principal and interest payments) has been provided by operating cash flow. On the UCA statement, look to see if Net Cash After Operations is adequate to cover financing costs, which include interest expense and dividends. If so, the next subtotal on the statement—Net Cash Income—will be positive. Then, check to see if Net Cash Income is adequate to cover the company’s debt service, or current portion of long-term debt. If so, Cash After Debt Amortization will be positive. If either Net Cash Income or Cash after Debt Amortization is a negative number, it is likely that your customer’s interest and/or debt service was covered by additional debt (perhaps drawing on your line of credit) or by an equity infusion.

The accountant-prepared direct method cash flow statement does not provide these two interim sections (Net Cash Income and Cash After Debt Amortization). In a traditional direct method statement, interest expense is included in operating expenses, and debt service is incorporated in the financing cash flows section. Similarly, there is no explicit measure of debt service from operating cash flows on the indirect method cash flow statement. The UCA format has been adapted by banks from the traditional direct method statement largely to enable you to evaluate debt service coverage from operating cash flows. Although you certainly can interpret cash flow coverage using an indirect method statement or the traditional (non-UCA) direct method statement, consider the advantages of using the UCA format to isolate debt service coverage from operating cash flows. Most of the vendors of automated financial statement spreading programs provide the UCA report option in addition to the indirect method statement.
Analyzing Investing Cash Flows

When using an indirect method statement, focus on the Investing Cash Flows section. On a direct method statement you should focus on capital expenditures and long-term investments. Investing cash flows includes cash flow from investment activities, such as buying and selling plant and equipment, rental properties, and stock in affiliates or subsidiaries. Changes in marketable securities are also classified as an investment when the securities are held for long-term investment rather than as cash equivalent.

When a company has not disposed of any long-term assets, investing cash flow will include only expenditures to acquire long-term assets. Investing activities are negative for most companies until they enter a declining stage in their life cycle, i.e. they reinvest less than they dispose. If a company has positive investing cash flows, you should determine if this is a one-time event or a trend. If the investing cash flow is negative, ask questions to determine future requirements.

Analyzing Financing Cash Flows

- With an indirect method cash flow statement, focus on the Financing Cash Flows section of the report. Using a direct method or UCA statement, focus on the reported changes in external debt and equity. For both methods, these changes tell you how the company financed its total cash requirement or how it disposed of (invested) any cash surplus.

The direct method looks at changes in short-term debt, long-term debt, and equity less the current portion of long-term debt (CPLTD) that has already been considered in the operating cash flows.

The indirect method first combines new borrowing and repayments of short-term debt and discloses the net change. Then, it combines that number with separate figures for advances of long-term debt, repayments of long-term debt, and increases and decreases in net worth (other than from profits or losses).

Lenders prefer to see sources of cash flow that increase net worth because that increase represents a margin of protection. On the other hand, positive cash flow from increased debt can increase the leverage of the company. The netting of increases and decreases in short-term debts limits your ability to understand how much total debt the company might have placed or repaid during the year, or the high and low borrowing points. You need to refer to the footnotes included in the financial statements to get more information.

CASH FLOW RATIO ANALYSIS

There are several ratios that will help you evaluate cash flow:

Cash Margin Ratio (Direct or UCA Direct Cash Flow)

Using the direct method cash flow statement, compute by dividing gross cash profit by net sales. The result is an indication of the percentage of each sales dollar that remains as cash after payment of all production (for a manufacturing company) or acquisition (for a wholesaler or a retailer) costs.

\[
\text{Cash Gross Profit} \quad \frac{\text{Cash Gross Profit}}{\text{Net Cash from Sales}}
\]

Debt Service Coverage Ratio (Indirect Cash Flow)

\[
\text{Net income} + \text{Depreciation} + \text{Amortization}
\]
CPLTD

Or

\[
\frac{\text{Net Profit} + \text{depreciation/amortization/depletion} + \text{extraordinary gains (losses)} + \text{interest}}{\text{Interest Expense} + \text{CPLTD}}
\]

These ratios are commonly used based on an indirect method cash flow approach, but have severe limitations:

- Both imply that all net income has equal cash potential
- Neither accounts for major demands on cash flow such as:
  - Capital expenditures
  - Dividends
  - Working Capital changes because of sales growth or declining efficiency
- Both imply that loan repayment will have a first claim on cash flow

**Fixed Charge Coverage Ratio (Indirect Cash Flow)**

\[
\frac{\text{Earnings before Interest and Taxes (EBIT)} + \text{Lease and Rental Expense}}{\text{Interest Expense} + \text{Lease and Rental Expense} + \text{CPLTD}}
\]

Or

\[
\frac{\text{Earnings before Interest, Taxes, Deprecation and Amortization plus Lease & Rental Expense (EBITDAR)}}{\text{Interest Expense} + \text{Lease and Rental Expense} + \text{CPLTD}}
\]

This measure also uses an indirect approach to measuring cash flow and has the same limitations as the Debt Service Coverage Ratio. This measure recognizes that the borrower may have recurring charges, such as for an operating lease, that compete with loan payment for the company’s cash flow.

**Cash Coverage Ratio (UCA Direct Cash Flow)**

\[
\frac{\text{Net Cash after Operations}}{\text{Financing Costs} + \text{CPLTD}}
\]

This ratio addresses the question of whether the borrower is able to meet its debt obligations, both principal and interest, as well as any dividend payments, from internally generated cash. Note that dividend payments are included as part of Financing Costs. Calculated by dividing net cash after operations by financing costs plus scheduled payments on long-term debt. A ratio of greater than 1:1 indicates no reliance on external financing to make the required payments. A ratio of less than 1:1 means that a company must raise external financing elsewhere (under its short-term line of credit, from new long-term debt, or...
from shareholders) to service its obligations to lenders and to stockholders and to fund its capital expenditure requirements.

**Adjusting Cash Flow Analysis for Off-Balance Sheet Events**

In Dimension 3, we discussed the fact that certain balance sheet adjustments can be made and incorporated in your ratio calculations, such as the leverage calculation. The adjustments in question could include capitalizing operating leases, adding off-balance sheet commitments and contingencies, estimating pension liability, and estimating recourse liability for securitized receivables. If you have made these adjustments to fine tune your evaluation of a customer’s leverage, you should also consider determining if any of the adjustments are likely to result in cash outlays in the intermediate term. In other words, if you are using financial projections to assess repayment ability in the next three to four years, consider the potential cash impact of the guarantees or other contingencies.

In the very near term, you generally do not need to be concerned about cash impact of these adjustments. If you are receiving audited financial statements, and if the company’s Auditor identified a reasonable probability that the company would need to satisfy a contingent liability, that amount would be recorded as a current liability in the statements you are evaluating. However, in the second year and beyond of your projection, you should consider the likelihood of outlays to satisfy these contingencies.

You also do not need to be concerned about adjusting for operating leases in your cash flow analysis, as the statement of cash flows already reflects the actual cash outlay for lease payments. However, remember to consider the operating leases when identifying cash flow coverage using the fixed charge coverage ratio.

**Analyzing Financial Efficiency—Cash Flow Drivers**

By understanding the quality and demands of cash flow, you can utilize the following cash flow-related ratios to fine-tune the analysis and stress test the company’s ability to repay debt. Not surprisingly, ratio analysis focuses on the business fundamentals and the swing factors. In combination, they are the primary determinants of cash flow. Together, business fundamentals and swing factors are sometimes called “cash flow drivers.” These are the critical ratios that require “what if” analysis when reviewing any projections for the company.

We analyze Business Fundamentals using four ratios that evaluate the company’s key profitability components. We analyze Swing Factors using three turnover ratios that relate to the company’s efficiency in managing its working capital assets.

**Business Fundamentals**

With the exception of sales growth, the following ratios are accrual accounting measures of performance:

- Sales growth
- Gross profit margin
- Operating expense percent
- Operating profit margin
Sales Growth

\[ \frac{\text{Sales Year 2} - \text{Sales Year 1}}{\text{Sales Year 1}} \times 100 \% \]

Sales growth usually causes an increase in a company’s working capital investment, as each new sales dollar creates a receivable dollar (if sales are all on credit), and new sales are supported by new inventory, of which purchased components are financed using new trade credit. To estimate the cash impact of sales growth based on working capital growth, multiply the growth percentage times each working capital component. The table below illustrates a worksheet to estimate this cash impact.

<table>
<thead>
<tr>
<th>Working Capital Component</th>
<th>Year 2 Sales Growth %</th>
<th>= Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/R $ end of Year 1</td>
<td>Times Year 2 sales growth %</td>
<td>= Cash Impact</td>
</tr>
<tr>
<td>Inventory $ end of Year 1</td>
<td>Times Year 2 sales growth %</td>
<td>= Cash Impact</td>
</tr>
<tr>
<td>A/P $ end of Year 1</td>
<td>Times Year 2 sales growth %</td>
<td>= Cash Impact</td>
</tr>
<tr>
<td>Total cash impact of growth</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Receivable and inventory growth consumes cash, so their cash impact should be recorded in brackets. Payable growth provides cash, so its cash impact should be recorded as a positive number.

Gross Profit Margin

\[ \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 \% \]

Changes in the gross profit margin impact cash flow. A higher profit on each sale means the customer keeps more of each sale dollar; a lower profit means the customer keeps less of each sale dollar. Although the gross profit is calculated from the accrual income statement, and thus there is not a direct correspondence between gross profit dollars and gross cash profit dollars, a change in the profit percentage of each sale nonetheless drives the ultimate cash collection from each sale. You may estimate more accurately if you eliminate any depreciation expense in cost of goods sold before calculating the gross profit margin.

To estimate the cash impact of a change in the gross profit margin, first calculate the change in the gross margin (i.e. 45% in year 2 minus 44% in year 1 = a 1% improvement). Then, multiply the change percentage times the second year’s sales.

<table>
<thead>
<tr>
<th>Gross Profit Margin</th>
<th>= Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in gross margin %</td>
<td>Times Year 2 sales dollars</td>
</tr>
</tbody>
</table>

RMA

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If the gross margin increased, show the cash impact as a positive number. If it decreased, show the cash impact in brackets, as a decrease in the gross profit margin reduces cash from each sale.

**Operating Expense Percent**

\[
\text{Operating Expense Percent} = \frac{\text{Operating Expense}}{\text{Net Sales}} \times 100 \%
\]

Very similar to the gross profit margin, changes in operating expenses as a percent of sales either provide or consume cash. To make a more accurate estimate, eliminate any depreciation expense from operating expenses before calculating the operating expense percent.

To estimate the cash impact of a change in the operating expense percent, first calculate the change in this ratio (i.e. 22\% in year 2 minus 20\% in year 1 = a 2\% increase in expenses). Then, multiply the change percentage times the second year’s sales.

<table>
<thead>
<tr>
<th>OPERATING EXPENSE %</th>
<th>Times Year 2 sales dollars</th>
<th>= Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in operating expense %</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

If the operating expense percent decreased, show the cash impact as a positive number. If it increased, show the cash impact in brackets, as an increase in operating expenses reduces operating cash flow.

**Swing Factors**

Swing factors, measured by turnover ratios, are also called efficiency ratios and relate to how efficiently the company manages its accounts receivable, inventory, and accounts payable. Loss of efficiency consumes cash, and increases in efficiency provide cash to the company. The swing factors are:

- A/R days outstanding
- Inventory days outstanding
- A/P days outstanding
**Accounts Receivable (Days)**

\[
\text{Accounts Receivable Days} = \frac{\text{Accounts Receivable} \times 365}{\text{Net Sales}}
\]

If a company has collected its receivables faster than in the prior year, it has shortened its cash cycle. The reverse is true if collections have taken longer. To estimate the cash flow impact of a change in the number of days’ sales in accounts receivable, first calculate the change in A/R days (i.e. 38 days in year 2 less 36 days in year 1 = a 2-day improvement). Then, multiply the change in days times one day’s average sales for year 2.

\[
\begin{array}{c|c|c}
\text{Change in A/R Days} & \text{times Year 2 sales dollars} & = \text{Cash Impact} \\
\hline
\text{accounts receivable days} & 365 & \\
\end{array}
\]

- If A/R days decreased, show the cash impact as a positive number. If it increased, show the cash impact in brackets, as an increase in the A/R portion of the cash cycle reduces cash flow.

**Inventory (Days)**

\[
\text{Inventory Days} = \frac{\text{Inventory} \times 365}{\text{Cost of Goods Sold}}
\]

If a company has reduced its inventory days on hand compared to the prior year, it has shortened its cash cycle. The reverse is true if inventory days on hand have grown. To estimate the cash flow impact of a change in the number of inventory days on hand, first calculate the change in inventory days (i.e. 63 days in year 2 less 59 days in year 1 = a 4-day loss of efficiency). Then, multiply the change in days times one day’s average cost of goods sold for year 2. For a more accurate estimate, eliminate any depreciation from cost of goods sold before calculating inventory days each year.

\[
\begin{array}{c|c|c}
\text{Change in Inventory Days} & \text{times Year 2 COGS dollars} & = \text{Cash Impact} \\
\hline
\text{inventory days} & 365 & \\
\end{array}
\]

- If inventory days decreased, show the cash impact as a positive number. If it increased, show the cash impact in brackets, as an increase in the inventory portion of the cash cycle reduces cash flow.

**Accounts Payable (Days)**

\[
\text{Accounts Payable Days} = \frac{\text{Accounts Payable} \times 365}{\text{Cost of Goods Sold or Purchases}}
\]
If a company is receiving less trade credit and thus has reduced its accounts payable days compared to the prior year, it has lengthened its cash cycle. The reverse is true if payable days have grown. To estimate the cash flow impact of a change in the number of accounts payable days, first calculate the change in payable days (i.e. 45 days in year 2 less 41 days in year 1 = a 3-day loss of efficiency). Then, multiply the change in days times one day’s average cost of goods sold for year 2. For a more accurate estimate, eliminate any depreciation from cost of goods sold before calculating inventory days each year. Also, if you have enough detail to isolate purchases from cost of goods sold, using purchases instead of cost of goods sold will be more accurate, as trade credit is extended only for purchased goods, not for the many other components of cost of goods sold typical of a manufacturer.

<table>
<thead>
<tr>
<th>Accounts Payable Days</th>
<th>Change in A/R Days</th>
<th>times Year 2 COGS or purchases</th>
<th>= Cash Impact</th>
</tr>
</thead>
</table>

- If payable days increased, show the cash impact as a positive number. If it decreased, show the cash impact in brackets, as a decrease in the payables portion of the cash cycle reduces cash flow.
Analyzing the Cash Flow Drivers

It is useful to look at all the cash flow drivers together, to be able to see which of the three driver families (sales growth, fundamentals, or swing factors) had the most influence over cash flow trends during the years you are analyzing. Construct a worksheet similar to the following to see the cash flow drivers for one year. Replicate the worksheet for multiple years of analysis.

### SALES GROWTH

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
<th>Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/R $ end of Year 1</td>
<td>Times Year 2 sales growth %</td>
<td>= Cash Impact</td>
</tr>
<tr>
<td>Inventory $ end of Year 1</td>
<td>Times Year 2 sales growth %</td>
<td>= Cash Impact</td>
</tr>
<tr>
<td>A/P $ end of Year 1</td>
<td>Times Year 2 sales growth %</td>
<td>= Cash Impact</td>
</tr>
</tbody>
</table>

Total cash impact of **growth**

### GROSS PROFIT MARGIN

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
<th>Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in gross margin %</td>
<td>Times Year 2 sales dollars</td>
<td>= Cash Impact</td>
</tr>
</tbody>
</table>

### OPERATING EXPENSE %

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
<th>Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in operating expense %</td>
<td>Times Year 2 sales dollars</td>
<td>= Cash Impact</td>
</tr>
</tbody>
</table>

Total cash impact of **fundamentals**

### A/R DAYS

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
<th>Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in A/R Days</td>
<td>times Year 2 sales dollars / 365</td>
<td>= Cash Impact</td>
</tr>
</tbody>
</table>

### INVENTORY DAYS

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
<th>Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Inventory Days</td>
<td>times Year 2 COGS dollars / 365</td>
<td>= Cash Impact</td>
</tr>
</tbody>
</table>

### A/P DAYS

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
<th>Cash Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in A/P Days</td>
<td>times Year 2 COGS or purchases / 365</td>
<td>= Cash Impact</td>
</tr>
</tbody>
</table>

Total cash impact of **swing factors**
As you analyze cash flow driver trends, focus on the changes that made the largest impact on cash flow. These are the result of management decision-making, and your analysis should suggest to you the particular variables to which the company’s cash flow is most sensitive. Your discussions with management should focus on whether they are purposefully managing the most important cash flow drivers, or if outside influences (such as suppliers or competitors with aggressive price strategies) are most influencing the cash flow drivers. You can easily use these worksheets to estimate future cash sensitivity to changes in the cash drivers. For example, if you are concerned that a customer might risk extending too generous terms to secure additional sales, you can use the A/R days portion of the worksheet to test the cash impact of an additional few days’ receivables. Similarly, you can use the sales growth portion of the workshop to test the cash impact of sales growth your customer is hoping to achieve.

Being able to perform sensitivity analysis on key variables in this fashion helps you quantify a range of potential management decisions, enabling you to estimate debt service and of course, to engage in a productive discussion of growth options with your customer.

**Alternate Cash Flow Measures**

Two alternate methods lenders often use to measure cash flow are:

- Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) or Earnings Before Interest, Taxes, Depreciation and Amortization and Lease and Rental Payments (EBITDAR)
- Free Cash Flow

EBITDA and EBITDAR were discussed previously in this section and also in Dimension 3. These measures are often incorporated in loan agreement financial covenants, because they are simple to calculate and in the case of EBITDA, well understood by most borrowers. However, neither is a calculation that is defined under GAAP. In addition, neither tool measures cash flow as accurately as the direct method Statement of Cash Flows. In a perfect world we might wish to specify a measure such as Net Cash After Operations from the UCA direct method cash flow statement when defining the numerator of a debt service coverage measure. Unfortunately, few borrowers and their accountants prepare a UCA direct method cash flow statement, and it is generally not wise to specify a loan covenant that requires a measurement that only the bank has access to. For this reason, lenders are generally constrained to using the traditional cash flow measure—usually EBITDA—to communicate cash flow requirements to borrowers, even while using the more accurate direct method cash flow statement to analyze creditworthiness.

In this section of Dimension 4 we will briefly discuss each alternate cash flow measure, noting its limitations.

**EBITDA**

Earnings before Interest, Taxes, Depreciation and Amortization is calculated just as the tool’s name implies: Net profit before tax, plus interest expense, plus depreciation expense, plus amortization expense. This measure is often the numerator for a debt service coverage ratio, which divides EBITDA by interest expense plus current portion of long-term debt.

As mentioned earlier, the value of this tool is in its ease of calculation, and because it is the near-universal language of cash flow. However, EBITDA has many flaws as we noted earlier:
• It implies that all net income has equal cash potential.

• It does not account for major demands on cash flow such as capital expenditures, dividends or working capital changes caused by sales growth or declining efficiency.

• It implies that loan repayment will have a first claim on cash flow.

If your customer has few non-operating income sources and very little sales growth, and if its swing factors remain very constant over time, and if capital expenditures are generally similar to annual depreciation expense, it is possible that an EBITDA measure of cash flow will provide a reasonably accurate assessment of cash flow. However, these four ‘ifs’ are very significant conditions not likely to be true for most companies. The cash flow consumption of even modest sales growth will not be reflected in an EBITDA measure, nor will EBITDA reflect the cash consumed by efficiency losses that cause the cash cycle to lengthen.

In all likelihood, you are constrained to use EBITDA or a derivative measure such as EBIT or EBITDAR in your loan documents. Keep in mind its limitations as you establish covenant levels. Try to identify minimum EBITDA-based coverages that will trigger a loan default before or at the same time that Net Cash After Operations (NCAO) from the UCA direct cash flow statement is no longer sufficient to cover financing costs and principal payments. Your best strategy for understanding the EBITDA/NCAO correspondence is to use an automated spreadsheet program to run projections that sensitize sales growth and the swing factors. The spreadsheet programs provide EBITDA-based ratios as well as NCAO-based coverage ratios, and you can work with a variety of sensitivity scenarios until you determine how much sales growth, or how many days’ change in the swing factors, appear to cause NCAO to significantly diverge from EBITDA.

**FREE CASH FLOW**

There are many variations of the Free Cash Flow model in use by financial institutions today. All Free Cash Flow variations attempt to measure the amount of annual after-tax cash flow generated by internal operations, after making required investments. In other words, it is the annual cash flow available to repay debt, pay dividends, and buy back stock.

One measure of Free Cash Flow begins with the indirect method cash flow statement’s Net Cash Provided by Operating Activities (NCPOA). As companies that provide a cash flow statement almost always choose this format, this measure is generally available. Free Cash Flow is calculated as:

\[
\text{Net Cash Provided by Operating Activities} - \text{Capital expenditures} - \text{Other investments or plus Sales of investments} + \text{Interest expense net of tax benefit} = \text{Free Cash Flow Available to Service Debt}
\]

The advantages of this cash flow measure are that it is easy to calculate, available to bankers and borrowers alike, and that it explicitly accounts for both capital expenditures and any cash consumed by sales growth or working capital efficiency losses. The model’s principal limitation is that it assumes all capital expenditures are required investments, when indeed most companies have a mix of replacement and growth capital expenditures. Growth
capital expenditures may be discretionary, and if removed from the calculation would more accurately portray funds available for debt service.

An alternative to this is not to adjust for interest, and the end result is the amount of cash flow that is available for principal repayment, dividends and stock repurchase. In some instances, the Free Cash Flow analysis is utilized to determine loan repayment. For those scenarios you should consider not adding back interest and only deducting maintenance capital expenditures. The advantage to this approach is it is possible to determine how long it will take to recoup both principal and interest on debt.

Other variations of Free Cash Flow may be based on net profit after tax, net operating profit after tax, or EBITDA. In most cases, the measures adjust for working capital increases and capital expenditures to acknowledge those required cash outflows. However, some models do not correct for the complications of income tax. That is, for tax-paying corporations, interest is paid in pre-tax dollars while principal is paid in post-tax dollars. If the calculation uses Net Profit after Taxes, interest should be adjusted to post-tax dollars. If the calculation uses Net Profit before Taxes (or EBITDA), then principal should be adjusted to pre-tax dollars (i.e. ‘grossed up’ by dividing by 1-the tax rate).

There is no standard calculation of Free Cash Flow. If your bank has a version specified by loan policy, of course that is the version you should use in your analysis.

Comparing Cash Flow to Industry Peers

Just as you use peer analysis to gauge a borrower’s financial performance in terms of similar-sized companies in the same industry, you should review industry-specific cash flow indicators. There are no particular benchmarks or rules of thumb for cash flow measures, but it is very good practice simply to note whether your customer exhibits liquidity similar to peers, or diverges significantly enough to prompt a closer analysis.

RMA’s Annual Statement Studies provide you with both traditional debt service coverage ratio comparisons and UCA direct method cash flow statement measures.

Discovering Borrowing Causes and Repayment Sources

In this Dimension we have discussed analyzing your customer’s cash cycle and how to understand and interpret overall cash flow using a variety of cash flow analysis tools. Now it is time to apply that cash flow analysis to the problem of identifying your customer’s financing needs. In this section, we will relate your understanding of cash flow sources and uses to discovering your customer’s borrowing causes and repayment sources.

Borrowing causes are not always the same as stated loan purposes. By identifying the borrowing cause, you can:

- Determine if the borrowing needs will be long term or short term, thereby establishing a realistic repayment period.
• Estimate the amount of borrowing that will be needed, thereby avoiding surprises and an underestimation of risk.

• Identify what must happen for the company to repay, thereby assessing more accurately the risks of repayment and the need for secondary sources of repayment.

You can categorize most borrowing causes in five groups:

2. Current-asset growth resulting from declining efficiency.
3. Fixed-asset expenditures.
4. Changes in trade credit.
5. Decreases in net worth.

For each borrowing cause you identify, decide if it will:

• Reverse and free up cash for repayment.
• Stabilize, requiring repayment to come from other sources.
• Continue or accelerate, absorbing more cash and requiring repayment from other sources.

IDENTIFYING BORROWING CAUSES

Here is a review of the five common borrowing causes, how to identify them, and how they should be funded.

Current-Asset Growth Resulting from Sales Growth

When sales increase, so does the need of most companies for assets. When the sales increase is permanent rather than temporary or seasonal, the asset increase, even the increase in current assets, is permanent. Analyzing the cash flow drivers enables you to quantify the cash impact of sales growth. Borrowing that results from long-term sales growth will generally need to be long term.

• You can use the asset turnover ratios to measure the relationship of a company’s sales to its assets. For example, the ratios can help you determine asset growth due to sales increases and/or asset growth because of changes in efficiency.

• Cash required for investment in higher permanent levels of current assets can be obtained from decreases in other assets, from increases in net worth, or from increases in liabilities. The soundest way for a company to fund permanent increases in current assets is with permanent or long-term sources of funds, such as increases in net worth, higher permanent levels of accounts payable, or loans that can be repaid over a long period.

• To identify how a company has met its need for funds in the past, look for the largest increases in liability or net worth accounts and the largest decreases in asset accounts. Examine each source to decide if it is temporary, such as temporary shrinkage of an asset that will need to be replenished, or long term, such as increases in retained earnings. When long-term borrowing causes have been met with temporary cash sources (such as loans that require short-term repayment), anticipate additional borrowing to replace liabilities as they become due or to replenish depleted assets.
Current Asset Growth Resulting from Declining Efficiency

This category includes the growth of current assets caused when receivables and inventory turnover slow down. To identify the efficiency declines:

- Use the asset turnover ratios and isolate the increases from lower turnover. Remember that the cash flow drivers tool enables you to estimate the cash effect of changes in the swing factors—in this case, accounts receivable and inventory management. These cash effects closely mirror the asset growth required to support changes in efficiency.

- Decide if asset increases are temporary or permanent. Increases that will not shrink to former levels quickly or that will have to be replenished immediately if they do shrink are permanent.

- Find the sources of cash the company has used to meet the needs and determine whether they are temporary or permanent. Permanent increases should be funded with sources that do not have to be reduced in the short run; otherwise, additional borrowing will occur to replace liabilities that must be reduced.

- If the swing factors are trending negatively, it is important to discuss the reasons with your client to determine if it is a planned strategy (i.e. allowing longer terms on receivables as a competitive advantage) or if there is something else at play. For instance, it may be that the company has not been focusing on collection of receivables, or perhaps that there are receivables that will not be ultimately collectible. It may well be that your borrower is not aware of the effect on cash that turnover ratios have. You may be in a position to add considerable value by pointing out what impact collecting receivables more promptly, for instance, could have on cash availability and interest expense (assuming the average level of operating lines would reduce as a result).

Fixed-Asset Expenditures

Fixed-asset expenditures merit special attention because:

- The need to make fixed-asset expenditures is often what motivates a company to seek bank loans.

- Fixed-asset financing often requires large loans and long repayment periods, both signs of higher risk.

- Fixed-asset expenditures often trigger related but unanticipated borrowing requirements. Astute lenders anticipate additional cash needs related to fixed-asset expenditures, such as:
  - Costs of equipment set-up and installation, relocation expenses, and lost production time.
  - Possible distraction of management from other tasks.
  - Increases in inventory associated with new storage space or more work-in-process.
  - Working capital requirements if higher sales result from added capacity.
  - Increased expenses of maintaining the property.

Fixed-asset expenditures usually must be supported by increases in net worth or by loans that allow a long-term repayment schedule. It is important to understand whether capital expenditures are discretionary or necessary to maintain the performance of the company.
**Changes in Trade Credit**

Increases in accounts payable to the trade can be temporary or permanent, providing short-term or long-term sources of funds to a company. Decreases in payables can also be temporary or permanent, causing short-term or long-term borrowing needs.

Think of accounts payable as the first place to look for funds to support increases in current assets, especially inventory.

To measure cash supplied or used by changes in trade credit, use either days’ COGS in payables or days’ purchases in payables, and measure the impact on cash of a change affecting one day’s COGS or one day’s purchases. Your cash flow drivers tool will help you measure this impact.

You need to understand the terms provided by the company’s suppliers. If days’ COGS is increasing significantly and not within terms offered, it may be a sign that your customer is stretching payables and at risk of being placed on a cash basis. Alternatively, if suppliers offer terms for early payment, your borrower may be losing a significant amount of cash in terms of discounts on cost of goods sold.

**Decreases in Net Worth**

Decreases in net worth pose special risks for lenders if the decreases are permanent, such as when dividends exceed profits, when there are losses, or when the company repurchases stock. These risks are:

- The company’s resources (and earning power) are diminished.
- Repayment usually requires change rather than continuation of a trend.
- Replacing net worth with debt has a double impact on leverage and decreases the lender’s margin of protection in asset values.

Net worth decreases that are temporary, such as regular dividend payments that are covered by profits, sometimes cause borrowing to finance timing differences between cash receipts and disbursements within the same year. Those loans are less risky because they do not require a long period or a change in the company’s operation to be repaid.

**Using Cash Cycle Analysis and the Cash Flow Statement to Interpret Borrowing Causes**

The UCA direct cash flow statement provides a format that is particularly useful for interpreting borrowing needs. The statement is organized so you can evaluate first, sources and uses of cash flow for operating needs, then for capital expenditures and long-term investments, and then sources or uses related to external financing and net worth changes. The statement format enables you to easily see if sources of operating cash flow are adequate to meet operating cash requirements, or if there is a borrowing need to satisfy unmet operating cash uses.

While the cash flow statement quantifies any operating cash flow need, to understand its underlying causes requires secondary analysis that we have discussed in this Dimension. That is, cash cycle analysis and the related ‘swing factor’ cash flow drivers enable you to ‘drill down’ on operating cash flow needs by quantifying cash consumed by sales growth and any efficiency changes. The earlier discussion of seasonality should help you understand...
how to distinguish between temporary and permanent working capital financing needs caused by sales growth.

Understanding borrowing causes is key to appropriately structuring loans, which is the subject of Dimension 6.
Developing Cash Flow Projections

The purpose of a projection is to help determine whether your customer can repay your institution’s debt based on reasonable estimates about the company’s future operating strategy and management’s ability to implement it.

Cash flow projections are:

- A quantitative assessment of the future financial performance and financing needs of a company
- A forecast of a company’s ability to repay debt from its internally-generated cash
- A test of the vulnerability of a company to possible risks that may affect its repayment capacity

A set of cash flow projections:

- Provides a range of possible outcomes based on how a company may perform under a variety of economic and competitive conditions.
- Determines whether possible outcomes, or results, are within acceptable ranges for lenders.
- Provides the foundation for identifying the key drivers for a company and how much fluctuation creditors can tolerate.
- Identifies the factors that will assist you in determining the best loan structure.

Key Projection Reference Points

There are four key reference points that are used to build a projection:

- Past operating results of a company
- Objectives and goals of a company for the future as defined by management and outlined in a business plan
- Likely impact of economic, competitive, and regulatory factors on a company
- Supplemental action plans and alternatives available to help management meet performance projections

Of these four reference points, the first one represents hard data: the historical record of a company’s operating results. The other three points represent a subjective assessment, assumptions used to derive it, and the ability of you and your credit committee to interpret the results of what is likely to happen.

Information available to you to reduce the amount of uncertainty involved when making a set of projections can include:

- Historical records of a company’s financial position, including past years’ financial statements, relationship manager reports and client interviews (when available), credit reports, etc.—in short, your customer’s credit file
• Management reports: business plan, strategic objectives, mission statements, management forecasts, and projections

• Industry reports such as those prepared by RMA and applicable industry associations (see Credit Considerations and Industry Study Packs by RMA).

• Economic reports, analyses, and forecasts on both the macroeconomic, and the microeconomic level (see IHS industry outlook reports published by RMA).

**KEY PROJECTION ASSUMPTIONS**

A cash flow projection is only as good as the assumptions made by you in conjunction with the company’s management. The key to developing assumptions is to focus on the cash flow drivers:

• Sales growth %

• Gross profit margin %

• Operating expense %

• Operating profit margin %

• Accounts receivable (days)

• Inventory (days)

• Accounts payable (days)

There are other income statement and balance sheet variables that must be established in the process of developing projections, but they will not have the magnitude of influence on the projections that these cash flow drivers will. Most suppliers of financial spreadsheet software have a projection module that you can employ in analyzing projections.

In developing a credible set of assumptions for the cash flow drivers, they must be constantly tested for reasonableness, given the company’s historical financial performance, industry forecasts, the capacity of the company’s PP&E, and the depth and strength of the management team.

**USING SENSITIVITY ANALYSIS**

Once a realistic set of projections has been developed, do a sensitivity analysis or stress test on one or more of the variables. In a perfect world, the sensitivity analysis should be conducted by your customer. However, if that is not possible you should discuss both the approach and the results with your customer.

The purpose and function of a sensitivity analysis are to:

• Identify and assess the key/critical financial variables. These variables, when changed, will positively or negatively affect the future financial performance of the company and its ability to service debt.
• Identify what would cause the change in these critical variables (external factors, management actions, and so forth)

• Determine the amount of change in the drivers that can occur without materially affecting your customer’s ability to service its debt.

The primary reasons you should conduct a thorough sensitivity analysis include:

• The analysis enables you to determine whether your customer can repay its debt in less favorable business and economic circumstances.

• It shows whether the amount of financing requested is sufficient given all the demands on the company’s cash flow, particularly if there are material adverse changes in some of the underlying assumptions.

• It indicates whether you have identified all the key areas in your customer’s operations and financial condition that need to be monitored throughout the life of a loan, so that deterioration in these key areas does not adversely affect its repayment.

• It determines, in light of prospective changes, the most reasonable loan structure.

• It enables you to say that all the possible developments that might relate to the repayment of your customer’s debt have been considered and therefore the risk has been fully evaluated.

To perform a sensitivity analysis, follow these steps:

• Identify the most critical financial variables that appear to have the most significant potential impact on financial performance, and especially operating cash flow. For clues to critical variables, evaluate the cash flow drivers for recent years. You may either hand calculate the cash flow drivers, using worksheets similar to the one presented earlier in this Dimension, or review your bank’s automated financial spreading software’s cash management report, which provides cash flow driver information.

• As you examine historical cash flow drivers, identify which drivers seem to have had the most significant influence on cash flow in the past. Then, consider which drivers are most susceptible to change in the future. Drivers that have tended to cause a significant cash impact in the past, and which are also highly susceptible to near-term change, are critical financial variables.

• Once you have identified the critical financial variables, use a series of financial projections to test a range of values for each critical variable, in each projection case holding all other variables constant. Your goal is to answer a double-faceted question:

  ➢ What is the break-even value for this variable to produce an acceptable financial performance outcome; i.e. a projection outcome that yields acceptable profit, leverage, and cash flow to service the projected debt?

  ➢ How likely is it that the borrower will achieve a value for this variable that achieves the break-even value you have identified?

To determine the break-even value for each critical variable, you must run a series of projections for the variable, changing values in very small increments until you observe the repay/can’t repay point. For example, if you have determined that the gross profit margin is a critical variable, you must determine the minimum gross
margin required to produce a projection that demonstrates acceptable profit, leverage, and that generates sufficient Net Cash after Operations to service the proposed debt.

The most reasonable means of performing these projections is to use an automated spreading software program, if your bank uses this technology. Keep in mind that most automated spreading packages ‘balance’ the projection by assuming any financing requirement will be satisfied through short-term borrowings, such as draw-downs under a line of credit. Therefore, as you check for adequate Net Cash after Operations to service projected long-term debt, you must also check the balance sheet to determine if other variables (notably capital expenditures) incurred a financing requirement that in turn caused projected line borrowings that remain within your line approval amount. If the line has exceeded approval limits, then the sensitivity case you have tested—the gross margin %—is not adequate to produce a satisfactory case for loan repayment.

- After you have determined the break-even value for each of the identified critical variables, run a projection that incorporates the break-even values for each of the critical variables. It is very likely that this projection will not itself be a break-even projection, and you must then try to find out which of the key variables need to be stronger than their individual break-even values to provide an acceptable repayment outcome when combined with the other critical variables. This process includes some trial-and-error procedure, but with experience you will learn to quickly isolate the combination of minimum performance values of individual variables needed to produce the ‘whole’ break-even projection.

- Revisit the second key projection question: having identified break-even values for key variables individually and in combination, how likely is it that the borrower’s performance will fall within these ranges? What are some scenarios that can realistically interfere with the company’s ability to achieve each break-even variable? How likely are these scenarios to occur? The range of events and circumstances that might interfere with achieving a break-even value for critical variables is different for each borrower, but might include:

  - Interest rate changes
  - Competitors’ price changes
  - Supply interruptions
  - Labor shortages
  - Technological change in the industry
  - Currency exchange rate changes
  - Cost increases for key inputs

The process of conducting a sensitivity analysis should uncover the options or lack of options that are available to a company and a lender in developing a relationship. You might consider doing both a “most likely” case as well as a “pessimistic” set of projections to ensure that the debt can be repaid even in the most difficult of times as delineated by that pessimistic set of projections.
Once projections have been stress-tested for their reasonableness, they should be shared with management to assess their degree of comfort with the final results. It is the projections against which you will covenant the loan.
Dimension 5:
Evaluate Collateral Values and
Conduct Periodic Inspections of Collateral
**Purpose of Dimension 5**

The purpose of *Dimension 5* is to review skills required to evaluate collateral. Key topics in this Dimension include:

- The Concepts of Quality and Verifiability of Collateral
- Securities and Investments as Collateral
- Accounts and Notes Receivable as Collateral
- Inventory as Collateral
- Plant and Equipment as Collateral
- Intangible Assets as Collateral
- Understanding the Real Estate Appraisal

**The Concepts of Quality and Verifiability of Collateral**

Evaluating collateral begins with an understanding of the borrower’s asset quality and valuation. These topics are included in the *Dimension 3* study guide materials, which you should read prior to reading this discussion of collateral considerations.

In this section, we will review specific considerations for evaluating assets commonly taken as collateral. Collateral concerns can be divided into two comprehensive areas:

- **Quality.** How “good” is the collateral: What is its value, and how readily can we expect to realize that value in the event of liquidation?
- **Verifiability.** How accurate is our assessment? Does the collateral conform to representations made by the borrower regarding type, quantity, and quality? Do we have the means to test the accuracy of the borrower’s representations for the type of collateral under consideration?

The primary types of property we will discuss in this section are:

- Securities and investments
- Accounts and notes receivable
- Inventory
- Plant and equipment
- Intangibles

For additional information on evaluating quality of collateral, see also *Dimension 3* for discussion of evaluating cash and cash equivalents.

For information about securing and perfecting interests in collateral, see *Dimension 6*, which also includes information about verifying insurance coverage of collateral.

**Securities and Investments as Collateral**

*Note: comments in this discussion pertain only to commercial loans for purposes other than to purchase or carry margin stock, and for which the marketable securities are pledged or*
assigned as collateral. Loans made for the purpose to purchase stocks on margin are outside of the scope of this discussion.

Marketable securities include stocks, bonds (both government and corporate), bankers acceptances, commercial paper and mutual funds. Investments may include stock in privately held corporations, or ownership interests in limited liability companies, partnerships, etc. To qualify both marketable securities and investments entails analyzing two key considerations: value and liquidity.

**VALUE**

The term ‘marketable’ implies publicly traded issues. Generally speaking, shares or securities issues by private companies have very limited collateral value. You may be asked to consider the pledge or assignment of interests in private companies, however, either because your borrower has an investment in an affiliated company, or because an individual has proposed providing his or her personal interest in a private company as collateral for a commercial loan. Consider the following issues pertaining to publicly issued and private securities.

*Publicly Traded Securities*

- Marketable securities that are publicly traded have easily determined values but are generally subject to price volatility.
- Although market and other influences mean the values of publicly traded securities are volatile, considerable information is often available to help assess a likely range of near- and intermediate-term value. This includes:
  - Market price trends, including fifty-two week high and low, to evaluate volatility.
  - Market capitalization. If an issue has less than two billion dollars in capitalization, it is considered a small stock issue and value may be unusually volatile from the disproportionate impact of transactions initiated by institutional investors.
  - Analysts’ research reports, which may be available for mutual funds in addition to individual securities issues.
  - Public debt or commercial paper rating.
  - Industry trends, often included in analyst report comments, or the product of your own research.

  Keep in mind that analysts and rating agencies’ assessments are not guarantees of future value. Most marketable securities are subject to event risk, including a wide range of potential events and circumstances that can interfere with even expert assessment of future asset value. Examples include market response to world events, economic sector performance announcements, individual company earnings announcements, etc.

- The borrower’s portfolio management strategies can aid in the preservation of collateral value. Identify the individual responsible for maintaining the marketable security portfolio and discuss the following issues:
  - What is the composition of the portfolio? Is it a well-balanced mix of securities, including equities and fixed income securities? Are maturities of income securities diverse?
Are there concentrations within the portfolio? Concentration analysis should include both issuer and industry.

Is the portfolio actively managed, and if so, by whom? What are the credentials of the individual managing the portfolio?

What is the portfolio’s historical profitability trend?

**Non-Publicly Traded Securities and Ownership Interests**

The value of non-public securities can be difficult to assess without a diverse and observable market to establish trading prices. In general, you should discount 100% the collateral value of private securities or ownership interests unless valuation has been verified through acceptable analysis. Acceptable analysis may include, in the order of most to least credible, professional business valuation, earnings or book value multiple based on market conditions, or book value net of intangibles. If a value is verified, you will still need to discount the value by a reasonable margin before considering as a source of secondary repayment, depending on perceived demand for the shares based on outside factors which may affect the value at various points in time.

- The best way to determine the value of securities in a private firm is to obtain a valuation analysis created by a qualified valuation expert. In Canada, the primary designation for Certified Business Appraisers is The Canadian Institute of Chartered Business Valuators, although others such as Chartered Financial Analysts or CA’s, CMA’s or CGA’s may also have experience in this regard.

- Private company valuations are usually performed using a discounted cash flow model. These models require assumptions regarding:
  - Estimated future cash flows.
  - Cost of capital and appropriate discount rate, adjusted to reflect illiquidity of the company shares.

Assuming you have a valuation, and that valuation credentials are acceptable, keep in mind that there is still a significant difference between valuation-based share value and collateral value. In most cases the illiquidity discount does not fully reflect the practical limitations to where the bank might market shares of a private company. If there is no practical market for sale of shares of a private company, there is no effective value as collateral for a commercial loan.

- A private company may offer shares of a related company or a subsidiary as collateral for a loan. In addition to the valuation issues discussed above, there may be material correlation between the financial performance of the two companies. A deteriorating condition of the parent company (and your borrower) may have a spill-over effect on the affiliated company whose shares are your collateral. Consider also that a business unit’s stock securing a parent’s debt represents only the residual value of that business unit after any direct claims against the unit’s assets. If the business unit has liabilities, there may be little residual value of the business unit’s assets to provide the secondary repayment source for the parent company’s loan. However, there can be circumstances where one or more valuable assets—such as a license or a patent—have been transferred to a business unit that otherwise has no business activity and is protected from liabilities. In that case, the parent’s pledge of its business unit’s stock may have material value as collateral for the parent’s debt. For additional considerations
concerning the possible collateral value of intellectual property, see the discussion of intangible assets as collateral later in this Dimension.

**LIQUIDITY**

Securities provided as collateral for commercial loans should be easily transferable to the bank and readily convertible by the bank into cash should the bank need to realize proceeds from the collateral. Liquidity considerations include:

- Are the securities widely traded? Securities that are thinly traded may be difficult to sell at short notice.
  - Securities should be listed on a national exchange, such as the Toronto Stock Exchange or TSX Venture Exchange in Canada or the New York, American, or NASDAC exchanges in the U.S.
  - Mutual funds should be quoted in public indexes, such as the Globe and Mail or Financial Post
  - Rated issues should have minimum ratings as specified by your bank’s own guidelines, to ensure there is a value range that ensures continued, active trading in the issue.
  - Securities should be trading at minimum values, generally at least $10 per share.
  - Securities must be freely tradable and not subject to any limitations and that the percentage of the company held as security is not sufficient to affect the market if traded.

- If a private issue, are the securities certificated? To be available as collateral, the securities must be evidenced in a format that lends itself to perfecting a security interest. See Dimension 6 for a discussion of related perfection issues.

- Do the securities have legal or regulatory restrictions to sale? A good policy when considering accepting any stock offered as collateral for a business loan whether offered by a business entity or an individual, is to specifically ask if there are any legal restrictions on sale of the stock.

- Do the securities have sale or transfer restrictions that preserve the entity’s tax status. For example, limited liability companies and partnerships generally have limitations on the sale or transfer of their ownership interests, often to preserve a tax distinction from a corporation.

- Are the securities required for transactional purposes? These securities may have limited practical value as collateral. Consider:
  - What is the purpose of the securities portfolio? If securities pledged or assigned as collateral are required for daily liquidity purposes, consider whether there is a track record of replenishing the portfolio to maintain value and to ensure liquidity.
  - Do you intend to perfect a security interest in the securities offered as collateral? Perfection of marketable securities is accomplished through possession, or by control agreements (see Dimension 6 for a detailed discussion of perfecting a security interest in marketable securities and deposits). Taking possession or executing control agreements may hinder the borrower’s ability to use marketable securities or deposits for liquidity purposes.
Accounts Receivable as Collateral

There are two major considerations when determining the value of accounts receivable. The first and obvious consideration is the gross dollar amount of the receivables outstanding, accompanied by analysis of the client’s own historical turnover trends and comparisons to industry peer groups. More important, however, is the intrinsic value of the receivables shown on the borrower’s books. The intrinsic value considers the overall collectibility of the receivables, which is influenced by several factors:

**Account Customers.** It is critical to understand to whom the borrower is selling and whether these companies are good credit risks. The borrower should have adequate credit procedures in place to manage its exposure, and the overall industry should be healthy. A weakened industry may mean that the borrower is taking higher overall credit risk because of weakened customers.

**Credit Practices.** The borrower’s payment terms to its customers must be understood. Liberal returns and allowances policies, frequent or standard prepayments, or progress billings can signal collection problems. Continued shipment to customers in arrears also suggests questionable credit practices.

**Accuracy.** The accounts should be accurately stated. The company should have accounting systems and procedures in place to permit an accurate assessment of the status of the collateral, and fraud protections should be built into administrative procedures.

**Dilution** is one of the most important considerations in determining the value of accounts receivable as collateral. Typical causes of dilution include:

- **Allowances, discounts, or co-op advertising.** These are examples of negotiated changes to standard pricing. For example, a retailer may earn discounts or allowances based on sales volume levels or in exchange for favorable shelf space. The discount or allowance amount is applied to outstanding receivables, reducing the net value of the receivable balance.

- **Returns.** Goods shipped and billed may contain defective merchandise, either in whole or in part. An excessive amount of credits may signal a product quality problem. Credits may be issued in partial payment of an outstanding receivable.

- **Bad debts or write-offs.** These may be uncollectible accounts or perhaps individual, disputed sales transactions that are ultimately written off.

- **Contra Accounts.** When the borrower both sells to and buys from a company, receivables may be offset by the corresponding payable amount. Although in practice the two parties may continue to pay each other’s invoices, in bankruptcy or if amounts are disputed, the customer/vendor may insist on the offset.

Depending on borrower practices and procedures, dilution can range from a very small amount of receivables (5% or less) to much more significant amounts. It is essential to determine a borrower’s dilution experience and to adjust the gross receivables accordingly.
EVALUATING ACCOUNTS RECEIVABLE

To verify the amount and value of accounts receivable requires specific examination of the borrower’s accounts, plus review of related cash accounts. Asset-based lenders typically require a comprehensive field examination, conducted by qualified audit professionals, to identify any collateral risks and to help establish the appropriate loan-to-value percentages. Even if your financial institution does not have a formal asset-based lending program (ABL), it is helpful to understand the scope of an accounts receivable field exam. In the following paragraphs we will describe typical cash and accounts receivable examination tests, which will help increase your understanding of collateral risks and how to assess them.

Cash Accounts Exam

The objective of the cash accounts exam is to determine if cash is being properly received and accounted for and if disbursements are properly documented. The cash accounts exam complements the accounts receivable exam in that it follows the transaction from sale/receivable to collection.
Typical cash accounts exam procedures include:

**Verify Deposit Activity.** The examiner verifies that deposit activity correlates to the bank’s understanding of the handling of cash accounts. For example, in the case of a borrower whose ABL facility operates through a cash collateral account, the examiner will verify that all remittances have, in fact, been sent by customers directly to the lockbox. Any exceptions are noted in the exam report, and the examiner checks to determine if those exception items were immediately deposited into the cash collateral account by the borrower.

**Identify Unusual Disbursements.** The examiner looks for any unusual or significant cash disbursements. Such disbursement activity may provide clues to changes in company policies and procedures or prompt questions that could lead to meaningful insights. For example, large payments to attorneys may be retainers to support impending litigation; payments to officers and shareholders may be restricted by loan agreement and in need of verification against covenant formulas.

**Investigate Suspicious Transactions.** The examiner looks for evidence of fraudulent activity. An experienced examiner may note unusual payment patterns or questionable disbursements that trigger a deeper inquiry.

**Accounts Receivable Exam**

The objective of the accounts receivable exam is to determine if the receivables are fairly stated and if they are valid and collectible. There are a number of areas of exposure for loss of accounts receivable collateral value. The most significant include:

**Bill and Hold.** The client may receive an order from a customer and book it to accounts receivable, but instead of shipping immediately, holds the goods. Reasons for holding are variable, but they can be as simple as merely waiting for additional instructions from the customer. If funds have been advanced against the receivable and the customer subsequently cancels the order, the collateral is worthless.

**Prebill.** The client bills the customer for goods that have not yet been shipped. Prebilling almost always signals an attempt to overstate sales and receivables. If the client cancels the order or the client fails to ship the goods, the bank’s collateral is worthless. In some circumstances, notably where progress billings are an agreed-on element of the sale, prebilling is not an attempt to create fraudulent collateral. Progress billings need to be evaluated in each circumstance to determine whether they represent advanceable collateral; typically, the answer is no, but arguments can often be made that support acceptance of progress billings as collateral. The relationship between the borrower and its customer is an important determining factor.

**Partial Shipments.** The client bills the customer for a valid order but ships only a portion of the goods. The receivable submitted to the bank for funding represents the entire order, meaning the true collateral is insufficient to cover the full advance against the receivable.

**Prepayments.** The client receives some or all of the payment before shipping the goods. If the client cancels the order, or in the event of client bankruptcy, some or all of the payment may have to be returned to the customer. In that event, the bank’s collateral would be deemed nonexistent.
Dilution. Discounts, allowances, returns, contra accounts, and other credits may reduce the collectibility of the stated receivables. These credits may be posted or unposted. A growing balance of credits may signal product quality control issues or sloppy selling practices. Credits can also be fraudulently issued and receivables rebilled to remove delinquent collateral from the aging list.

Poor Credit Quality. Poor credit practices yield poor collateral. If the client sells consistently to questionable accounts or if overall credit quality deteriorates, the bank’s collateral deteriorates as well. It is important to review credit practices regularly, particularly if there is a significant departure from historical aging or turnover trends.

Payment may be withheld for lack of performance. In some cases, the sale of goods or services relies on some type of performance by the vendor, such as an ongoing warranty. If the financial institution tries to realize on the account receivable as security, the customer might well claim that the funds are no longer payable if the ongoing warranty is no longer available.

Intercompany Receivables. Intercompany receivables are not arms-length transactions. In liquidation, the bank may find the account parties not in sympathy with the bank’s need to collect, and/or the value of the receivables may have been overstated. In either case, the collateral value of these receivables is questionable.

Fictitious Receivables. The client may submit to the bank for funding receivables that are fictitious, from either a genuine customer or a fictitious account party. In either case, there is obviously no collateral to support the advances.

Consignment Sales. The client has placed goods on consignment with an account debtor, and these sales are not completed by the client until resale by the account debtor. The client owns the merchandise until its account debtor has sold it, and thus there is not a valid receivable and no collateral to support an advance.

Unbilled Receivables. The client may have sold goods or provided services, but no invoice has been issued. These may be collectible by the bank and thus used as collateral to support an advance, but there is risk to the bank because the ultimate invoice amount is subject to dispute.

Bonded Receivables. These are usually receivables from contractors, where the contractor was required to be bonded on a project. If the contractor does not complete the project and instead the bonding agent completes it, the bonding agent will have a priority lien on project receivables.

Guaranteed Sales. Common when clients sell to retailers, guaranteed sales include contract provisions guaranteeing that if the retailer cannot sell the goods, the vendor (your client) will take them back. Thus sales are contingent and therefore not strong collateral support for advances.

Accounts Receivable Exam Procedures.

The receivables examination procedures are designed to identify and quantify the loss exposure areas as outlined in the preceding discussion. Examinations will differ according to
bank policies and procedures, as well as in response to specific needs dictated by customer relationships or industry peculiarities. Typical receivables exam procedures include:

**Reconcile and Verify the A/R Aging.** The examiner reconciles the client’s aging to the client’s general ledger and financial statements, as well as to the reports supplied by the client to the bank to support borrowing requests. The aging should reconcile in each case, and any discrepancies are investigated and reported to the ABL relationship manager. One example of an adjustment that bears further investigation is a credit adjustment to the receivables by the company’s outside accountants. The outside accountant may have deemed the adjusted receivables to be uncollectible.

Discrepancies between the company’s internal records and reports filed with the bank may relate simply to timing differences (bank reports as of the 15th of the month; book agings generated at month-end). These discrepancies may, however, indicate tampering with the records to support fraudulent borrowing requests.

Verifying the aging means to verify if the accounts are as current as the borrower represents them to be. Verification involves taking sample invoice records from the aging and verifying them with the actual invoices on file. The examiner checks the invoice date, due date, and invoice amounts against what is listed on the aging report. The examiner checks to be sure that the accounts are being aged properly and that old invoices are in fact moved across the aging until they are shown as past due. A comprehensive test includes looking for proof of the order, such as a purchase order, or a note in the file if an invoice is from a verbal order.

It is good policy to exclude from collateral all receivables from an account debtor whose balance owed to your client includes 90-day or more past due balances on individual invoices. You need to consider the likelihood that receivables being generated in the current period will be paid if those that are over 90 days are not. Your financial institution most likely has specific policies on what can be included as “good accounts receivable” for collateral purposes.

**Verify Shipment of Goods.** Shipping documentation is inspected to verify that shipment took place either the same day or one day prior to the invoice date. Bills of lading should be attached to the invoice, showing that the carrier actually signed for the goods. Quantities shipped are compared as marked on the invoice and on the bill of lading to check for evidence of partial shipments.

**Review the Timeliness of Payment and Credit Memo Posting.** The examiner reviews a sample of payment and credit activity to ensure the documentation is complete and the transactions have been posted in a timely fashion. Credit memos should indicate the original invoice number and the reason for the credit; the examiner looks for indications there may be continuing product quality problems. The examiner also ensures that credits are posted against their original invoices and not against older invoices to manipulate the past due accounts.

**Identify Customer Concentrations.** The examiner reviews the agings to determine if there are any significant concentrations of receivables from any one customer. Significant concentrations may mean that the client is exposed to financial difficulty should that business be lost to competitors or the customer fail to pay its invoices.

**Review Credit Approval and Collection Procedures.** The examiner reviews the client’s credit approval procedures, including verifying how closely those procedures are followed.
Questions asked include how the client sets credit limits; whether credit reporting agency reports are obtained; and whether and how often credit file information is updated. Collection procedure questions include criteria for classifying an account as uncollectible and the timing of write-offs; staffing resources for collection efforts; and general collection procedures.

**Review Management Information Systems (MIS) Adequacy.** The examiner reviews the type of automated accounting systems that support the receivables reporting. Focus of the review is to determine whether the systems permit comprehensive and timely reporting of the status of credit sales and whether the overall accounting systems in place contribute to a fair and accurate representation of the company’s receivables.

**Review Bad Debt Method and Reserve Adequacy.** The examiner reviews the client’s bad debt expense practices to determine if in compliance with generally accepted accounting principles (uses the allowance method) or if the client uses the direct write-off method. If the client uses the allowance method, the examiner reviews the adequacy of the allowance for bad debts as well as reviews the method for determining bad debt expense/the provision for bad debts.

**Determine Industry Practices.** In some industries extended invoice terms are the norm, and the examiner considers industry practices when evaluating results of agings tests and when reviewing credit and collection practices.

### Evaluating Notes Receivable

Notes receivable are promissory notes payable to your customer and may arise in the course of trade, such as converting an account receivable to a formal note when extended terms are granted. A note may also be the evidence of debt when an owner, employee or other party receives an advance from the company. Regardless of the reason for the underlying debt, it is important to ask the following questions when evaluating whether to take a promissory note as collateral:

- Who is the maker (signer) of the note?
- Does the maker demonstrate both ability and willingness to repay the loan evidenced by the note?
- What are the terms of the note, including term, payment schedule and interest rate?
- If the note currently requires performance, is the debtor making timely payments?
- Is the note secured, and if so, what are the nature and value of the collateral?
- Is the note guaranteed, and if so, does the guarantor have the resources and motivation to repay the loan evidenced by the note?
- Is the note negotiable or non-negotiable? To be negotiable, the note must be in writing, signed by the debtor, contain an unconditional promise to pay the named amount, and be payable either on demand or at a specified date. Most important, the note must be payable either ‘to the order of [XYZ Company]’ or ‘to bearer.’ If payable to a named creditor only (payable to XYZ Company) the note is not negotiable.

The bank can take either a negotiable or a non-negotiable note as collateral, but the bank has greater flexibility in disposing of the note (perhaps selling it) and greater protections in defense of taking the note as collateral if it is a negotiable note.
**Inventory as Collateral**

The quality of inventory as collateral is measured in a number of dimensions. Some of these areas are related to complex inventory accounting considerations outside the scope of this reading. In general, key considerations include:

- **Contents.** Inventory is often comprised of multiple components, such as raw materials, work-in-process, and finished goods inventory. As these components do not generally have equal value, it is important to determine how much of overall inventory is represented by each of these components.

  If you are lending on a formal borrowing base or margin, one significant risk is that the borrower may reclassify one component of inventory to another for the fraudulent purpose of increasing the advance rate on the collateral. For example, when the bank does not advance funds against work-in-process inventory, the borrower may prematurely advance not-quite-finished goods into finished goods to qualify them for working capital advances. Marketability of the bank’s collateral may be nonexistent if it is not practical to finish the product prior to sale or if the product cannot be sold in an incomplete condition.

  See the ‘General Collateral Guidelines’ discussion below for collateral considerations by class of inventory.

- **Costing/Accounting Methods.** The true cost of the inventory needs to be considered. When inventory advances are structured as a percentage of funds loaned against the inventory’s cost, understanding the inventory cost is essential. In many instances “soft” costs, such as overhead components, can be absorbed into inventory cost figures. Similarly, if freight is a large component of inventory cost, liquidation value will be impaired. The lender needs to verify that costing methods used are reasonable and that the carrying cost on the books reflects an accurate cost or market value, whichever is less.

  There is also the risk of deliberate overstatement of quantity or value. Fictitious inventory reports may be submitted, overstating the quantity of inventory on hand and thus diluting the bank’s true collateral value. Alternatively, costs to produce the inventory may be overstated or if the market value of the inventory has deteriorated, write-downs may not have been taken. In either of these cases, the bank’s advances, typically tied to inventory cost, will be excessive in comparison to the realizable collateral value.

- **Physical Condition.** The inventory should be “fresh” and in salable condition. Accordingly, it should be stored properly, kept in good condition, and sprinkler systems and security procedures should be appropriate to the nature of the inventory. Perishable inventory requires extra care and shortens the window of opportunity for liquidation.

  Keep in mind that in a liquidation, the bank will need to take responsibility for maintaining the condition of the inventory until it is sold. Inventory that requires costly care and maintenance will yield smaller proceeds, net of the incremental handling costs.

- **Marketability.** The inventory should be easily marketable. There should be good distribution channels to facilitate sales. The current state of the industry must also be considered, including whether there is an excess or shortage of the product on the market, or whether a new or substitute product is diverting sales. Marketability
impairments include being outdated or out of style, obsolete (or approaching obsolescence), requiring significant time or funds to complete, or being highly customized or specialized. Note that some types of inventory may not be legally marketed by the bank, such as alcohol or tobacco products. The worst-case scrap value of the inventory (by component) should be estimated to determine the lowest likely value to be realized in liquidation. Significant quantities of inventory tagged as returned or defective indicates impaired marketability.

- **Verifiability and Control.** Verification of inventory value is another key consideration. Tests to confirm inventory value are important to ensuring the value of the collateral is as represented by the borrower. Some seeming inventory may not be the borrower’s property at all, such as tool and die property on the borrower’s premises but owned by the company’s customers. In addition, the lender must evaluate the borrower’s inventory control systems to confirm that the borrower’s ongoing representations of collateral types, values, and locations can be relied on.

Ready access to inventory is key to realizing proceeds in a liquidation. The borrower must be able to demonstrate adequate control and tracking of inventory, i.e. be able to identify quantities by type and location and to regularly update this information. In the event of a liquidation, it is essential to have quick access to accurate records, so the bank can take control of the collateral in time to prevent any shrinkage while trying to verify its content and location. In addition, if there are special systems or equipment needed to maintain the inventory in salable condition (such as refrigeration units or security systems) it is best practice to ensure the bank has legal access to these systems, so it can maintain the assets during a workout or liquidation process.

Inventory that is not under proper security and control is subject to physical removal from the customer’s premises. To the extent the book value of the inventory is overstated by the pilfered amount, the bank’s collateral is undervalued with respect to advances against it.

- **Domicile.** The bank must have legal and practical access to the inventory. Where the inventory is located has implications for both. Inventory located outside the country, or located at the site of the borrower’s customer may present physical access difficulties. Inventory located out of the country may require hiring in-country legal counsel for access and disposal. For a detailed discussion of lien perfection procedures, including information about filing liens when the collateral is outside the borrower’s jurisdiction of domicile, see Dimension 6.

**Collateral Guidelines for Inventory Components**

There are no universal guidelines for acceptability of inventory components as collateral. Conventional wisdom suggests that finished goods inventory is the most valuable, followed by raw materials; in most cases, it is assumed that work-in-process inventory will yield little or no value to the lender in collateral liquidation. Conventional wisdom is often valid, but there can be exceptions.

General considerations for each class of inventory, with some notable exceptions you should evaluate, are:
• **Raw Materials.** Raw materials inventory can be interesting to the lender because the cost is generally easily identified. Particularly if the raw materials are a commodity product, there can be an easily identifiable market for resale (although commodity goods are highly subject to price volatility, making value in liquidation difficult to estimate). Viewing the raw material as another company’s finished goods (where appropriate) can cast a more favorable light on this inventory component’s marketability.

*Exceptions:* Raw material can be purchased partially processed, as in lumber cut to specific board lengths or can be a part that is specifically designed for use in the finished product and has limited other uses. In either case, the resale market is less clear.

• **Work-in-Process.** Costs can be difficult to define, depending on accounting conventions and at what state labor and overhead are imputed into the product. Unless there are similar competitors, an outlet for unfinished product may not exist, and any sale can be expected to yield minimal dollar value.

*Exceptions:* A manufacturer of custom machinery may progress-bill its customers. Where progress billing is a contractual obligation, the work-in-process (partially completed machines) may be viewed by some lenders as pre-sold inventory, with correspondingly high collateral value. It may also be practical for the lender or their agent to work with employees to finish the work-in-process, even after the company experiences financial problems and the products can then be sold as finished goods.

• **Finished Goods.** Generally viewed as having the most assured liquidation value, finished goods inventory has an identifiable market and sale price. Cost can be difficult to determine, depending on accounting conventions.

*Exceptions:* If the borrower is a dominant player in its industry, unloading the finished goods in liquidation may result in significantly depressed sales values as supply potentially outpaces demand. In addition, there are many factors that can influence the liquidation outcome, including product perishability, commodity versus specialized product type, seasonality/sales timing, and cost of disposition. Private label finished goods are poor collateral, unless manufactured to specific contracts that have a high likelihood of being honored.

**Evaluating Inventory**

Your inventory evaluation can include an onsite inspection (or several, if inventory is in multiple locations), review of customer inventory reports, or review of third party reports such as an inventory appraisal or an asset-based lending field exam report. Usually a combination of these methods is needed to adequately qualify inventory as collateral.

Evaluating inventory entails identifying any risks related to inventory contents and costing/accounting methods. In the paragraphs that follow, we will describe asset-based lenders’ typical inventory examination objectives and procedures to help explain the nature of inquiry needed to identify inventory risks and to determine the appropriate loan-to-value advance percentage. Whether you are employing the services of a third party inventory appraiser or field examiner, or you are conducting your own investigation, it is important to cover this full range of investigational topics to fully qualify your collateral.

In addition to profiling typical inventory exam procedures, we will also describe procedures for examining the borrower’s accounts payable and tax accounts. These support exam
elements complement the inventory examination, as they help verify that there are no hidden claims against the proceeds of the sale of inventory collateral.

**Inventory Exam Purpose and Procedures**

The objective of the inventory exam is to determine if the borrower’s representation of inventory is accurate and to assess the adequacy of the inventory as collateral for the company’s borrowings. There are a number of areas of exposure for loss of inventory collateral value, which we described at the beginning of this inventory discussion.

The inventory examination procedures are designed to identify and quantify the inventory loss exposure areas as outlined in the preceding discussion. Examinations differ according to bank policies and procedures, as well as in response to specific needs dictated by customer relationships or industry peculiarities. Typical inventory exam procedures include:

- **Analyze Components.** The examiner verifies the classes of inventory, generally raw material, work-in-process, and finished goods. A complete review of inventory components requires an understanding of the inventory conversion cycle to determine if movement of inventory from one class to another is consistent with the actual changes in the value added to the goods.

- **Test Cost of Sales.** The examiner reviews the method used to determine inventory cost, plus any general ledger adjustments. Adjustments are analyzed to determine if they fairly reflect the actual cost of the inventory on the books.

- **Confirm Valuation.** The examiner reviews valuation procedures and verifies that the inventory is being carried at the lower of cost or market. Sale value is compared with inventory value (cost) to determine margins and to verify the goods are salable above cost.

- **Assess Marketability.** The examiner reviews the overall inventory marketability, including distribution channels, gross profit margin analysis, comments regarding the general state of the industry, and a worst-case scrap value assessment. This review can include researching market trends, and includes analyzing the inventory to determine the percentage of inventory consisting of less marketable elements such as prior year’s models, styles, etc.

- **Validate Quantity.** The examiner conducts a test count of inventory, noting variances and recording explanations for them. The examiner generally reviews and comments on the overall reasonableness of the client’s inventory tracking methods.

- **Evaluate Physical Condition.** The examiner assesses the general physical condition of the inventory, noting any storage conditions or security lapses that could cause the inventory to deteriorate.
• **Identify Obsolescence.** The examiner reviews the inventory for obsolete and unsalable merchandise, noting particularly whether inventory ledger adjustments have been made to reflect the diminished value.

• **Identify Ineligibles.** The examiner makes note of any inventory categories that are not eligible for working capital advances and verifies these items have not been included with other eligible inventory on the borrowing certificates. For new or prospective clients, the examiner will formulate specific recommendations for portions of inventory that should not be eligible for financing.

• **Review Management Information Systems Adequacy.** The examiner reviews the type of accounting systems that support the inventory tracking and reporting. Focus of the review is to determine whether the systems permit accurate and timely assessment of the quantity and value of inventory.

**Accounts Payable/Taxes Exam Objectives and Procedures**

The objective of the examination of payables and taxes is to verify that all trade creditors and taxing authorities are being paid as required. Analysis of payables practices shows the effective leverage of inventory. Verification of tax payments is important because liens for unpaid taxes may have precedence over secured creditor liens.

The payables and taxes examination procedures are designed to verify outstanding payables balances and to compare payment practices with agreed-on terms. Examinations differ according to bank policies and procedures. Typical payables/taxes procedures include:

• **Review the A/P Aging.** The examiner reviews the client’s payables aging to determine if obligations are being met on a timely basis. Note is made of any intercompany payables, and agings are generally compared with similar prior periods.

• **Identify Payables Concentrations.** The examiner looks for any concentration of payables, which may indicate over reliance on a vendor or short supply of needed goods for manufacture or resale.

• **Identify Contra Accounts.** Vendors who are also customers are identified, and their receivable balance compared with the payable balance. The receivable amounts generally will be considered ineligible for financing.

• **Review Payment Terms.** The examiner reviews payment terms for significant vendors to determine if any unusual terms exist and to determine if any trade payables have been converted to notes payable.

• **Verify Tax Payments.** The examiner reviews tax returns and canceled checks to verify the tax amounts due were actually paid, and on time. Jurisdictional and local income taxes are checked, as are withholding amounts, payroll taxes, and personal property taxes.
Plant and Equipment as Collateral

General Plant and Equipment Questions

General questions to consider when evaluating plant and equipment include:

- Are facilities owned or leased?
- What is the location?
- What are the lease terms including options and Renewals?
- Is any portion being financed?
  - If so, who has the security interest?
  - In terms of environmental hazard issues, has there been any history of toxic waste disposal or storage on the property?
  - To the borrower’s knowledge, has there been any evidence of environmental hazard or event on any of the surrounding properties within at least five miles?
  - Has the property ever had an environmental assessment? When and who performed it? Would a copy of the assessment be available to the bank?
  - Is the current facility adequate to meet future needs?
  - Has there been a recent appraisal? What value was given to the property and equipment?

Evaluating Equipment

The value of equipment as a secondary repayment source depends on the following key considerations:

- Is the equipment general purpose or specialized? General purpose equipment has broad application inside and outside the customer’s industry, where special purpose equipment has a very narrow market.

- What is the age of the equipment? Newer equipment obviously provides greater collateral value than older equipment, and its value is generally easier to determine. Of equal importance is to ask how much of the equipment’s useful life has already expired. A two-year old machine that has a service life of only three years may be less valuable as collateral than a five-year old machine with a service life of 20 years. In a similar vein, equipment with remaining (and transferable) warranty protection may have more liquidation value than equipment without warranty protection.

- Is the equipment portable? Equipment that is permanently or semi-permanently affixed to real property presents liquidation problems. There may be legal issues regarding landlord rights if the real property is leased, and there will be costs and practical issues related to securing and transporting the equipment for sale.

- Is the equipment essential to the customer’s operation? Equipment that is essential to operations is likely to be better maintained than non-essential equipment, preserving collateral value. Also, if the loan is explicitly to finance equipment, loans for essential equipment are less susceptible to default than loans to finance non-essential equipment.
• Is the equipment uniquely identifiable? If there is a serial number or other characteristic that provides ready identification, the specific equipment serving as collateral will be easily determined. This is particularly important if there is a mix of lenders, or if some of the customer's equipment is leased from other financing sources.

• Is the equipment easy to maintain? If maintenance is simple and maintenance costs are low, it is more likely the equipment will remain in good condition and thus retain its collateral value.

• What is the current condition of the equipment? Equipment in good condition has greater value, and it is also suggestive of the customer's operational management practices. Similarly, it is important to find out in what setting the equipment is being used. Equipment being used in a very dusty or corrosive environment will not retain value as well as equipment used in a clean, climate-controlled building. Equipment used by companies that do not commit adequate maintenance training and resources will not hold its value.

• Is the equipment comprised of a few significant pieces of equipment or are there many smaller units? Handling and disposal costs are less if the equipment is concentrated, and costs can be significantly higher to liquidate a large number of small-value items.

• Does the equipment have a low rate of obsolescence? Equipment subject to little obsolescence has a higher value as collateral than equipment that will rapidly lose value in favor of newer technology. Also find out if there is any regulatory legislation existing or pending that will require expensive modification or even phase-out of the equipment.

• Is there an active secondary market for the equipment? The liquidation value of equipment may be readily estimated if there is an active secondary market in the equipment, and less time will be needed to market the equipment in liquidation.

• Is there a shortage or a surplus of this type of equipment in the customer's industry? A shortage suggests easier disposal at higher values; a surplus may suggest the equipment is no longer desirable, or is being phased out in favor of newer or alternate technology. In either of the latter circumstances, liquidation value is impaired.

• How do current industry trends impact the value of the equipment? For example, if an industry is in distress and there are consolidations, bankruptcies or downsizings in process, value of equipment used in production or manufactured as products by the industry may experience value loss as surplus equipment enters the market.

**REVIEWING AN EQUIPMENT APPRAISAL**

When reviewing an equipment appraisal, key questions to consider include:

• What are the appraiser’s credentials? There are several certifying bodies for equipment appraisers, including:
  - Canadian Personal Property Appraisers Group
  - Equipment Appraisers Association of North America

In addition, there are appraisal bodies that specialize in particular types of equipment, such as the American Association of Farm Equipment Appraisers in the U.S. In a formal equipment appraisal, the appraiser should identify his or her professional certification and memberships. Some of the certifying bodies provide multiple levels of certification (i.e. Certified Appraiser I, II, etc.). Several bodies subscribe to The Appraisal Foundation’s Uniform Standards of Professional Appraisal Practice (USPAP), which also governs real estate appraisal practices.
The appraiser’s statement of credentials should also include educational credentials and a brief description of professional experience, with any specialized knowledge and experience with relevant types of equipment noted.

- What is the purpose of valuation provided in the appraisal? The most common values specified are:
  - **Fair Market Value.** The price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts in the open market.
  - **Orderly Liquidation Value.** The amount of gross proceeds that could be expected from the sale of appraised assets under orderly conditions given a period of time in which to find a purchaser considering a complete sale of all assets, as is, where is and all sales made free of all liens and encumbrances.
  - **Forced Liquidation Value.** The estimated gross dollar amount that could typically be realized by a properly conducted public auction held under forced conditions under present day economic trends.

The valuation most commonly requested by financial institutions for collateral assessment is an orderly liquidation value.

- Has the appraiser certified that he/she:
  - performed a personal inspection of the equipment?
  - engaged in appropriate investigation and research, including evaluation of comparable equipment being offered for sale and actual previous sale data?
  - charged an appraisal fee that was not contingent upon any value estimate, and has no present or contemplated future interest in the property or the appraisal client that might tend to prevent making a fair and unbiased appraisal?

- Has the appraiser provided definitions to explain what is meant by descriptive terms such as ‘excellent,’ ‘very good,’ ‘good,’ ‘fair,’ ‘poor,’ and ‘scrap’ when describing the condition of appraised equipment?

- Has the appraiser commented on the collateral considerations noted under ‘Evaluating Collateral’ above? The appraisal narrative should discuss the value implication of many of the considerations we noted as having an impact on the value of equipment as collateral.

**PROTECTING YOUR ACCESS TO EQUIPMENT COLLATERAL**

You must order lien searches and obtain copies of all filings to determine whether you have or will have senior liens on collateral. Searches must be ordered from all locations in all Jurisdictions where financing statement filings are required at the time the loan is made. For example, under the Bank Act (which defines banks as those listed on Schedule I and II of the Act), security may be registered at the Bank of Canada. See Dimension 6 for a discussion of now to perfect a security interest in many types of property. Information about environmental assessments is also included in Dimension 6.

In addition, it is important to verify that adequate insurance is in place to protect the lender’s interest in the assets. Insurance questions to ask include:
• What kinds of coverage are maintained?
• What is the extent of coverage?
• Are all premiums current?
• Who is the company’s agent or broker?
• What is the nature and extent of claims filed in recent years? Are there any pending settlements?

Many factors that could negatively affect the value of your collateral and the ability of the borrower to repay its loan are unavoidable and cannot be insured against. For those factors that can be insured against, require proof that such insurance has been obtained and that your institution is an included insured party. Generally you should request that your bank be named as loss payee under a Standard Mortgage Clause as it provides that your right to coverage under the policy would not be affected or defeated by any act, neglect or default of the borrower.

**Intangible Assets as Collateral**

Intangible assets, like all assets, are claims to future values. Tangible assets represent either physical value claims (such as equipment or real estate) or financial claims (such as an account receivable, which represents a claim to future cash). Intangible assets represent nonphysical claims to future values and are generally recognized to fall into five categories:

• **Marketing-related intangible assets.** Typically these are trademarks and trade names that provide value through the owner’s ability to attract customers and/or charge a premium based on perceived benefits associated with the name.

• **Customer-related intangible assets**, such as customer lists and sales contracts. This type of intangible is most valuable in industries for which obtaining customers is a significant barrier to entry. For instance, major grocery stores frequently buy their produce only from established brokers. Once established, the broker’s customer list is very valuable. Another example of customer-related intangible assets is the customer maintenance contracts commonly owned by software companies. Covenants not to compete are also customer-related intangible assets.

• **Artistic-related intangible assets**, such as copyrights that provide value by establishing exclusive right to sell or license a work.

• **Contract-based intangible assets**, such as intellectual property licensed from another entity. One example would be a clothing retailer that owned the rights to use the Olympic rings in its clothing. A franchise agreement, or a company’s internet domain name might also be considered contract-based intangible assets.

• **Technology-based intangible assets**, more commonly referred to as patented technology, and including software.

There is great variation in terminology used to define intangible assets. For example:

• '...

• **Under the PPSA in British Columbia, “intangible”** means personal property, but does not include goods, chattel paper, a document of title, an instrument, money or a security, and a licence, while in under the PPSA in Ontario, “intangible” means all personal property, including choses in action, that is not goods, chattel paper, documents of title, instruments, money or securities; (“bien immatériel”)
• Accounting rules distinguish between intangible assets with finite (such as patents) indefinite lives (such as goodwill).

• Lenders often add to the list of ‘intangibles’ balance sheet accounts of dubious value, such as notes receivable from or investments in affiliated entities, when adjusting reported net worth to what we call ‘tangible net worth.’

• Assets such as those named above—trademarks, trade names, customer lists, sales contracts, copyrights, licenses and patents—are commonly referred to as ‘intellectual property,’ or ‘IP.’

For the purposes of this collateral analysis discussion, we will limit the topic to the intellectual property intangibles defined earlier. Most other assets included in the broader definitions, such as payment intangibles, have readily identifiable values. Others, such as goodwill, have values that are identifiable, but not separable from the owning entity, and thus do not typically provide collateral value.

IDENTIFYING INTANGIBLES SUITABLE AS COLLATERAL

Not all intangibles are suitable as collateral, including some intellectual property. To identify intangibles suitable as potential collateral, consider the following questions:

• Does the asset have value independent of the owning entity? Patents, trademarks, copyrights, trade secrets, customer lists and software are examples of intangibles that typically can be separated from the owning entity, which typically means they can be sold. Goodwill generally does not have independent value, although for legal reasons it is advisable to take a security interest in associated goodwill when securing certain assets, such as trademarks.

• Has a value been established for the asset? If so, how was the value established? Accounting rules for intangible assets require annual impairment tests and related value write-downs if an impairment has occurred. However, balance sheet value does not permit recognition of increased market value, which generally can only be reliably established through a formal valuation process. Appraisers of intellectual property and other intangible assets should be credentialed. The Appraisal Foundation’s Uniform Standards of Professional Appraisal Practice (USPAP) apply to intellectual property valuations. Valuation of intangible assets may be based on cost, market or discounted future cash flow approaches, similar to valuation of other assets. Each approach requires market specialists capable of performing independent research, with specialized knowledge of the borrower’s competitive environment, similar intellectual property in the industry, and recent sales or licensing of similar property.

• Has the asset been afforded all relevant legal protections, such as registration with the appropriate government agency? Some types of intellectual property, such as patents, need to be registered to protect rights. Other property, such as a copyright, does not require registration but registration is the best means of enforcing a claim of infringement against a third party. Generally, the more legal protections in place, the more likely the asset will provide value in a liquidation.

• Does the borrower actually own the asset? You should verify that the company has full legal ownership rights in its intellectual property. Licensed intellectual property may not be transferable. Even if a company paid for development of a proprietary copyrighted
work, it may not have full ownership rights if the property is considered a ‘work for hire’ and the company did not secure the appropriate assignments of copyright interest.

- Has the asset previously been used as collateral? If your customer provided intellectual property as collateral for an earlier financing, it is possible that the lender’s security agreement was effectively a means to assign the asset to the lender while licensing it back to the borrower. Ownership of the asset may have transferred to the lender in that event.

- What are the costs to maintain legal protections if the asset is intellectual property? Maintaining and defending legal protections can be very expensive. Patent, trademark and other legal protections have indefinite lives and require additional filings and fees to keep them in force. Defense of intellectual property infringement is expensive, both to protect the borrower’s property and to respond to suits alleging the borrower infringed on similar or pre-existing property.

- Have contract rights been thoroughly documented, and do they include any restrictions on sale, pledge or assignment? For both registered intellectual property and intangibles such as non-compete agreements and long-term supplier contracts, you should request information to determine whether there are any express restrictions on your ability to secure and perfect an interest in the asset. In rare cases, financial statement disclosures may provide relevant details, but generally you must request review of the relevant documents.
Understanding the Real Estate Appraisal

APPRAISAL DEFINITION

An appraisal of real property provides an estimate of the value of the property as of a defined point in time, based on current market conditions.

OSFI regulations state that if a real-estate related transaction is material an appraisal must meet the standards contained in the Uniform Standards of Appraisal Practice (USPAP) of the Appraisal Institute of Canada (AIC). Material is defined as representing greater than the lesser of 0.1 percent of the book value of the total assets of the company and $10 million. However, under OSFI, the decision as to whether an appraisal is required is left to the discretion of the financial institution. Regulatory requirements notwithstanding, for the lender the appraisal is one of the more important underwriting tools. It provides very useful information on:

- Overall market conditions
- Characteristics of the particular neighborhood in which the property is located
- Current market rental rates and operating expenses
- Value of land and any improvements

KEY APPRAISAL CONTENT

This discussion will familiarize you with the critical analytical content of the appraisal, its sequencing and the basic concepts or rationale for each appraisal section. You will normally find conclusions presented at the beginning and end of the report, with the salient supporting data and arguments laid out in the middle.

This is a fairly high-level discussion, as the actual content of an appraisal is much more comprehensive than as outlined here. Appraisal content not discussed in this section may include photographs of the site, site/parcel descriptions, project descriptions, title/lien priority data, surveys, etc. It is easy to see how on larger, complex projects appraisals can be 100 pages or more in length. Regardless of the length, a comprehensive review of the appraisal constitutes essential due diligence on any commercial real estate loan.

The major appraisal sections addressed in this section are:

- Highest and Best Use
- Three Approaches to Value
- Cost Approach
- Sales Comparison Approach
- Income Capitalization Approach
- Final Reconciliation of Value
HIGHEST AND BEST USE

_Highest and Best Use analysis_ is the balance point of the appraisal process and the appraisal report. In this analysis, the appraiser reconciles the economic and physical information presented in the beginning of the report and asks two questions about the subject:

*If the site were vacant, what would the optimum improvement be?*

*If the subject is improved, how do the existing improvements relate to the optimum improvement and current market expectations?*

The answers to these questions provide the foundation for the approaches to value the appraiser ultimately uses, as well as for the information considered in the valuation section of the report.

Application of the highest-and-best-use concept can be extremely involved and indeed requires a high level of analysis on the appraiser’s part. It is not a task to be undertaken by the un-credentialed real estate professional. However, the basic concept is fairly straightforward and focuses on the optimal value potential for the property. The following explanation paraphrases the concept:

**Highest and Best Use is:**

_The reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The highest and best use must meet: legal permissibility, physical possibility, financial feasibility, and maximum profitability._

The highest-and-best-use analysis of a site always focuses on the site as if it were vacant and available to be put to its best use on a specified date, irrespective of its current use. The highest and best use of an improved property focuses on what exists or will exist.

“Not the Highest and Best Use”

If the appraiser concludes that the existing or proposed improvements are not the highest and best use, the conclusion implies that some obsolescence is likely. The property may no longer make economic sense. The improvements will not result in the highest market value of the property. For example, imagine a small single-family residence on two acres in what was once a remote locale. Over time, urban and suburban sprawl have surrounded this property with high-density commercial development. Clearly the single family home does not maximize the utility and economic potential of the property. It is not the highest and best use. However, this may also imply that if converted to its highest and best use it may well have a higher value. In the example of the single-family residence, a rezoning of the property may well enhance its value.
APPRAISALS: THE THREE APPROACHES TO VALUE

Appraisals are only one tool in a lender’s toolbox. While appraisals are essential to making good real estate underwriting decisions, appraisers can and do make mistakes. Only by reading the appraisal, viewing the property, and combining good business sense with common sense and judgment can an appropriate decision be made regarding the loan. Remember: The appraisal alone will not determine the collectibility of your financing.

THREE APPROACHES TO VALUE

Standards of professional appraisal practice require that for most types of property, the appraiser must use three separate methods to estimate value. These methods are called the cost approach, the sales comparison approach (also called the market approach), and the income capitalization approach. The appraiser analyzes the values estimated with each method and then uses his or her judgment to correlate a final value.

Note: There can be circumstances in which the appraiser finds that one of these approaches is not applicable. One example is the appraisal of a parcel of vacant land on which no improvements have been constructed. Since the property is not generating income, the income approach is not applicable, nor is the cost approach, since there are no improvements on the property. In this example, the appraiser would use only the sales comparison approach, in which sales of comparable parcels of unimproved land are analyzed.

Types of Value

An appraisal of real property provides an estimate of the value of the property as of a defined point in time, based on current market conditions.

As the appraisal provides time-sensitive analysis, there are many measures of value for a given property. The value will be a function of the property’s completion status, lease status, anticipated premise for sale (e.g., liquidation), and so on. In ordering the appraisal, you should be very clear about what values you are requiring. Several definitions of value are:

As Is Value: See Value As Is (below).

As Built-Out Value: See Value Upon Completion (below).

Bulk Market Value: A misnomer; see also Gross Selling Price, Value Upon Completion and Value to a Single Purchaser (below).

Market Value: The most probable price a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is consummation of a sale as of a specified date and passing of title from seller to buyer under the following conditions:

- Buyer and seller are typically motivated
- Both parties are well informed or well advised and each acting in what he considers his own best interest
- A reasonable time is allowed for exposure in the open market
• Payment is made in terms of cash in U.S. dollars or in terms of comparable financial arrangements

The price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.¹

**Present Value:** The lump sum amount that represents the current value of the right to collect future payments.

**Prospective Value Estimate:** A forecast of the most probable value expected to occur at a specified future date. It is most frequently used in connection with real estate projects that are proposed, under construction, under conversion to a new use or that have otherwise not achieved sellout or a stabilized level of long-term occupancy at the time the appraisal report is written.

It is always based on the expectations and perceptions of market participants together with identifiable and documentable trends as well as data that are known or knowable at the time the forecast is made, and is a prediction.

**Transaction Value:** Means:

• For loans or other extensions of credit, the amount of the loan or extension of credit

• For sales, leases, purchases, and investments in or exchanges of real property, the market value of the real property interest involved

• For the pooling of loans or interests in real property for resale or purchase, the amount of the loan or market value of the real property calculated with respect to each such loan or interest in real property.²

**Value As Is:** The value of specific ownership rights to what physically exists and is legally permissible on an identified parcel of real estate as of the date an appraisal is written or the subject property was last inspected.

¹ Ibid.
² Ibid.
**Value to a Single Purchaser:** The price as of a specified date that a single purchaser could be expected to pay for a real estate project in which a portion of the overall rights in realty are expected to be sold to individual end users over time.

Value to a single purchaser implies that an informed purchaser would pay no more for a project at a specific point in time than the price at which he could acquire the property and cover all remaining direct or indirect costs expected to be incurred before sellout of all remaining units or lots.

Costs expected to be incurred in the achievement of sellout may include (but are not necessarily limited to) all remaining costs associated with completing construction or development. Additional sellout costs can include anticipated costs associated with marketing individual units or lots and maintaining the property during the *absorption* period; the cost of mortgage and equity capital expected to be incurred, plus a market-based level of entrepreneurial profit.

**Value As If Completed:** The hypothetical value of a property as if all proposed improvements, development, rehabilitation, modernization, remodeling or changes in use were accomplished on the appraisal date.

**Value Upon Completion:** The prospective value of the expected physical and legal position of an identified parcel of real estate on the date when any development, rehabilitation, modernization, remodeling or change in use has been physically accomplished.

This is a prospective value estimate predicated upon known or knowable data as well as the expectations of typically informed market participants as perceived on the date the appraisal is written.

**Value Upon Stabilized Occupancy:** The prospective market value of the expected physical and legal condition of an identified parcel of real estate on the date when any development, rehabilitation, modernization, remodeling or change in use has been physically accomplished and the property has attained its expected level of long-term occupancy. It contemplates a value estimate of the total ownership rights to the expected physical and legal condition of an identified parcel of real estate. It reflects the highest and best use of the expected physical and legal condition of the identified property rights on the prospective date of the value estimate.

It reflects the long-term economic feasibility of the identified property as it will physically and legally exist on the prospective date of the value estimate.

It is a prospective value estimate predicated upon known or knowable data as well as the expectations of typically informed market participants as perceived on the date the appraisal is written.

**Wholesale Value:** A misnomer; see *Value to a Single Purchaser.*
COST APPROACH

Basic Concept of the Cost Approach
The cost approach determines the value of the property based on its cost to complete, less depreciation. This approach is used any time there are improvements constructed on a piece of property. The only time this standard does not apply is when the appraiser determines that the improvements do not contribute any value to the property because of deterioration, deferred maintenance, obsolescence, or other factors.

The Process for the Cost Approach
The appraiser executes three basic steps in completing the cost approach.

- Estimate the value of the land as if it was vacant
- Determine the replacement or reproduction costs of the improvements, less any accrued depreciation.
- Sum the land value and the depreciated cost of the improvements to determine the value of the property.

An example follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated land value if vacant</td>
<td>$50,000</td>
</tr>
<tr>
<td>Estimated construction cost of a similar structure</td>
<td>$160,000</td>
</tr>
<tr>
<td>Less: Estimated Depreciation</td>
<td>($10,000)</td>
</tr>
<tr>
<td>Equals: Estimated Value of Building</td>
<td>$150,000</td>
</tr>
<tr>
<td>Appraised Property Value</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

To estimate the land value, the appraiser analyzes recent sales of vacant land similar to the property being appraised. Considerations for similarity include time of sale, zoning, size, location, topography, and access. Because two parcels of land are rarely exactly alike, the appraiser makes adjustments to the sales price of each comparable property to reconcile its value more closely to that of the subject property.

To estimate the value of the improvements, the appraiser uses one of various construction cost-estimating guides to determine the reproduction costs of the type of property being analyzed. There are several regional or national companies that provide cost guides classified by property according to the quality of design and construction, such as fair, good, very good, and excellent.
To estimate depreciation, the appraiser states whether the property suffers from any of four types of depreciation:

- Curable physical deterioration, resulting from deferred maintenance, which can be repaired.
- Incurable deterioration, which cannot be practically or economically corrected.
- Functional obsolescence or a loss in value stemming from the design of the building; may be caused by changes over time that make certain materials or a design obsolete.
- Economic obsolescence or the diminished utility of a structure because of outside influences, such as a declining neighborhood or depressed market conditions.

To arrive at an overall value of the property under the cost approach, the appraiser simply sums the land value and the cost of reproducing the improvements, minus any depreciation.

**Tips for Reviewing the Cost Approach**

Review the land comparables to ensure that appropriate properties have been analyzed.

Focus on the timing of the previous land sales. Real estate conditions can change rapidly, and a sale in excess of 12 months old may not reflect current market conditions. If the appraiser feels that market conditions have changed since the time of the sale, he or she should adjust the value accordingly.

Assess reasonableness of all adjustments made by the appraiser in determining the value.

Verify that the appraiser’s description of the quality of the improvements is properly reflected in the calculation of construction cost.

**SALES COMPARISON APPROACH**

**Basic Concept of the Sales Comparison Approach**

In the sales comparison approach, also known as the market approach, the appraiser determines the value of the property based on the prices at which other comparable properties have changed hands.

**The Process for the Sales Comparison Approach**

The appraiser executes five basic steps in completing the sales comparison approach.

- Search property sales records in a geographic area and extract an adequate number of properties similar to the subject that have recently been sold.
- Compare the subject property to those selected sales “comparables” (i.e., properties that possess similar characteristics).
• Determine an applicable unit of comparison to use in the analysis.

  Depending on the type of property, the unit of comparison may be the sales price per square foot of building area, the sales price per acre of land, the sales price per unit (for apartments and hotels), or a similar appropriate calculation.

  The appraiser may also extract the gross income multiplier (GIM) from the sale of income property. The GIM is calculated by dividing the annual gross income generated from the property by the sales price of the property. For example: a commercial property recently sold for $350,000 and the gross annual income is $50,000. The GIM would be 7 ($350,000 / $50,000 = 7).

• Compare each comparable to the subject and adjust each comparable sale (up or down) for various characteristics, including the time of the sale, size of the property, zoning, access, age, location, design, physical characteristics, and quality of construction.

• Based on this analysis of the comparable sales, determine the value of the appropriate unit of comparison and multiply the unit of comparison by the size of the subject property to determine the value in accordance with the sales comparison approach.

**Tips for Reviewing the Sales Comparison Approach**

Carefully review the description and location of each comparable property to determine if it is truly similar to the subject property.

Focus on the timing of each comparable and verify that older transactions have been appropriately discounted in the weighting for that factor.

Examine each comparable adjustment to see that they are reasonable, well-supported and consistent.

**THE INCOME CAPITALIZATION APPROACH**

**Concept of the Income Capitalization Approach**

The income capitalization approach, or cash flow approach, is critical in the valuation of income-producing properties. This method determines the value of the property based on its cash flow generating ability, or earnings power. The income capitalization approach converts future income expectancies into a stabilized value estimate. An estimate of property cash flow is established, the quality of the cash flow stream is assessed, and an investor rate of return is applied to the cash flow stream to calculate the value of the property.

In compiling the data required for this analysis, the due diligence procedures of independent confirmation apply. The appraiser will use actual lease documents on the subject and comparable properties as available, as well as data from other developers, investors, appraisers and real estate brokers. The data obtained will also be compared to the estimates of future property performance provided by the owner/developer.
The Process for the Income Capitalization Approach

The appraiser executes six basic steps in completing the income capitalization approach. Each step is discussed in greater detail below.

1. Determine the property square footage
2. Analyze contract rents in place and/or estimation of market rent to determine appropriate rental rates for the property. Multiply this rental rate by the appropriate square footage measure to calculate property’s gross potential income (GPI)
3. Deduct costs for vacancy and collection loss
4. Deduct costs for operating expenses
5. By sub totalling, calculate the property net operating income (NOI), or property cash flow
6. Convert the net operating income (NOI) into a value estimate by applying a rate of return, or capitalization rate

The income capitalization process and its relating calculations are demonstrated on the Income Property Cash Flow Worksheet using a sample property. We have also provided a blank Income Property Cash Flow Worksheet for your use.

Square Footage

For an accurate calculation of property rent potential and comparison of the subject property with other buildings, the appraiser determines the property square footage in various terms:

**Gross Square Feet** – The total amount of space in the property. This can include common areas, stairwells, elevator shafts, utility closets, corridors, lobbies, restrooms, and even loading docks.

**Rentable Square Feet** – How much space can actually be leased and will generate rent. A tenant will typically not pay directly for the space occupied by common areas, restrooms, etc., but may be allocated proportionate responsibility for these amenities.

**Usable Square Feet** – the amount of space the tenant will actually be able to productively use for their business.

The correlation between these square footage measures allows the appraiser to determine the overall efficiency of the property, which factors into the determination of rental rates which the property can achieve.

Rent Analysis

The appraiser researches rental rates of comparable properties. The rental rates are analyzed based on the characteristics of the property, such as location, design, access, overall quality and condition, age, and lease terms. The appraiser makes any adjustments to the rental rates of comparable properties deemed appropriate based on differences in these characteristics. Also, within the subject property different rent rates will be assigned based on the desirability of the space; a basement suite or an interior corner in a retail center would typically warrant a lower rental rate. Adjustments are made for these considerations as well.
The total rents for the property are referred to as the gross potential income (GPI). They are expressed in annualized terms and reflect both the rents from existing leases and the potential rent for future leases on space, which is currently vacant. This allows the appraiser to determine a value for the property, which assumes it is no longer in a state of flux; in the midst of lease-up. This prospective condition or status is called stabilized occupancy.

When analyzing rents, the appraiser will work to establish an effective rent for the property. An effective rent reflects the economic rent being paid for the space. Consideration and analysis of effective rents is necessary because the contract rent (the rent stated in the lease) is a function of tenant-landlord negotiation and quite often, concessions. These concessions allow the tenant to pay less for the space in real economic terms. For example, the lease may include free rent for a period of time, or cover a tenant’s moving expenses. Omission of effective rent analysis can dramatically overstate or understate the GPI and wildly distort the property valuation.

**Vacancy Analysis**

Logic says that there will always be some portion of the building that is not rented, because it is between tenants, under renovation, or for some other temporary reason. Additionally, rent collection may be an issue, particularly in multi-tenanted properties. The general convention is to express these factors as a percentage of total rentable square feet. In establishing a relevant vacancy rate for a property, the appraiser considers vacancy rates for properties similar to the subject property, and in the market overall while taking into account overall economic trends.

The vacancy factor is applied to the property’s gross potential income (GPI) and then netted from the GPI to calculate the property’s effective gross income (EGI).

**Operating Expenses**

Operating expenses are expressed on an annual basis per square foot or in percentage terms. If a percentage is used, that percentage is applied to the EGI. These expenses include utilities, taxes, management fees, maintenance, marketing, insurance, and legal and accounting fees, etc. Note, these expenses are relatively fixed. They are the ongoing costs of property ownership. If the rents fall by 20%, the property operating expenses will not necessarily reduce by a like amount. Likewise if rents escalate, expenses may not follow suit. It is important to consider this directly in valuing and underwriting real property loans.

Depending on how the lease is written, some operating expenses may be passed on to the tenant. In a gross lease, the building owner pays all expenses. Because of expense uncertainties, a gross lease will usually have a cushion built into the lease rate. A net lease passes some or all of the expenses on to the tenant. The most common type of net lease passes taxes, insurance, and maintenance expenses on to the tenants. This is typically called a “triple net” or “NNN” lease. The appraiser will carefully review the expense sharing arrangement in the subject and comparable leases to accurately measure the net expense burden to the property owner.
Reserve for Replacement Expenses
This is a provision for normal wear and tear requirements of a property. It will cover such things as re-facing the parking lot, replacing the roof, repairing the heating or air conditioning, and painting. In an apartment property it will include the cost of eventual replacement of dishwashers, refrigerators, carpets and ranges. Note that the allocation of a reserve in the appraiser’s calculation does not guarantee that actual dollars are being set aside for these purposes. These expenses are expressed on an annual per square foot basis.

Rollover Expenses
This includes the cost of redecorating, renovation, and leasing agent commissions incurred when space is re-leased. These costs apply even if the space is re-leased to the existing tenant. These expenses are expressed on an annual per square foot basis.

Rollover expenses can be very difficult to accurately quantify, particularly in a multi-tenanted property with irregular lease expirations. If this is the case, the appraiser will normally elect to complete the income capitalization approach using a discounted cash flow analysis.

Net Operating Income
Net operating income (NOI) is calculated by deducting the various property operating, reserve, and rollover expenses from the EGI as shown below on the Income Property Cash Flow Worksheet. NOI is an estimate of the property’s potential pretax, un-levered cash flow if leased in accordance with its own attributes and current market conditions. This is also referred to as the property’s stabilized NOI.

In commercial banking terms this is conceptually the same as recurring EBITDA (earnings before interest, taxes, depreciation and amortization).

Capitalizing the NOI
The final step in determining the value in the income capitalization approach requires the application of a capitalization rate (cap rate) to the NOI. The cap rate is an estimated market driven rate of return, which correlates to the risk profile of the property, among other things. The NOI is divided by the cap rate to calculate the value under the income capitalization approach. This is sometimes referred to as the value upon stabilized occupancy.
Blank Income Property Cash Flow Worksheet

<table>
<thead>
<tr>
<th>BUILDING TYPE</th>
<th>.................................................................</th>
</tr>
</thead>
<tbody>
<tr>
<td>Square Feet</td>
<td></td>
</tr>
<tr>
<td>x Revenues/Square Foot</td>
<td>$</td>
</tr>
<tr>
<td><strong>GROSS POTENTIAL INCOME</strong></td>
<td>$</td>
</tr>
<tr>
<td>Less: Vacancy % A</td>
<td>% ( )</td>
</tr>
<tr>
<td><strong>EFFECTIVE GROSS INCOME</strong></td>
<td>$</td>
</tr>
<tr>
<td><strong>EXPENSES</strong></td>
<td></td>
</tr>
<tr>
<td>Operating Expenses/Square Foot B</td>
<td>$</td>
</tr>
<tr>
<td>Reserve for Replacement/Square Foot C</td>
<td></td>
</tr>
<tr>
<td>Rollover Expenses/Square Foot D</td>
<td>$</td>
</tr>
<tr>
<td>Total Expenses/Square Foot</td>
<td>$</td>
</tr>
<tr>
<td>x Total Square Feet</td>
<td>( )</td>
</tr>
<tr>
<td><strong>NET OPERATING INCOME (N.O.I.)</strong></td>
<td>$</td>
</tr>
<tr>
<td>(Income Available for Debt Service)</td>
<td></td>
</tr>
<tr>
<td><strong>VALUATION ESTIMATE</strong></td>
<td></td>
</tr>
<tr>
<td>Capitalization Rate E</td>
<td>%</td>
</tr>
<tr>
<td>Estimated Value = N.O.I. ÷ Cap Rate</td>
<td>$</td>
</tr>
</tbody>
</table>

A  Average annual vacant space, expressed as a percent of total square feet.

B  Expenses such as utilities, taxes, management fees, maintenance, marketing, insurance, legal, and accounting, etc. Expressed on an annual basis.

C  Estimate of this year’s expense contribution toward future capital expenditures such as appliances, heating/cooling units, roof, and parking surfaces.

D  Expenses incurred to attract new or renewal tenants, such as redecorating, renovation, or reconfiguration of the space.

E  Blended rate that reflects market interest rates, risk levels for this property type, and the return investors want to see on instruments with similar risk characteristics.
**Building Type:** Office

<table>
<thead>
<tr>
<th>Square Feet</th>
<th>20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>x Revenues/Square Foot</td>
<td>$24.00</td>
</tr>
<tr>
<td><strong>Gross Potential Income</strong></td>
<td>$480,000</td>
</tr>
<tr>
<td>Less: Vacancy %</td>
<td>15 %</td>
</tr>
<tr>
<td><strong>Effective Gross Income</strong></td>
<td>$408,000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Operating Expenses/Square Foot</td>
<td>$6.00</td>
</tr>
<tr>
<td>Reserve for Replacement/Square Foot</td>
<td>.15</td>
</tr>
<tr>
<td>Rollover Expenses/Square Foot</td>
<td>.60</td>
</tr>
<tr>
<td>Total Expenses/Square Foot</td>
<td>$6.75</td>
</tr>
<tr>
<td>x Total Square Feet</td>
<td>(135,000)</td>
</tr>
<tr>
<td><strong>Net Operating Income (N.O.I.)</strong></td>
<td>$273,000</td>
</tr>
</tbody>
</table>

**(Income Available for Debt Service)**

**Valuation Estimate**

- Capitalization Rate: 10.5%
- Estimated Value = N.O.I. ÷ Cap Rate: $2,600,000

**Tips for Reviewing the Income Capitalization Approach**

Carefully review the description and location of each comparable property to determine if it is truly comparable to the subject property.

Focus on the timing of each comparable and verify that older transactions have been appropriately discounted in the weighting for that factor.

Examine all adjustments to see that they are reasonable, well supported and consistent. The rents and vacancy rates selected by the appraiser should be well supported by market evidence and the existing or anticipated operating expenses of the building should be compared with those of similar properties and/or to general industry expense figures.

Review the assumptions used in assigning the capitalization rate. If the appraiser has analyzed overall rates (“OARs,” the capitalization rates extracted from market transactions) from similar properties, the final capitalization rate should be in the same general range. If the appraiser feels that other factors (e.g., interest rate volatility, differences in risk levels due to location or owner-occupancy, etc.) will cause the capitalization rate to be out of line with the comparable’s OAR, these other factors should be discussed and supported.
**Capitalization Rates**

**CONCEPT AND DYNAMICS OF CAPITALIZATION RATES**

The capitalization rate (cap rate) is the vehicle used to quantify the value of a property’s cash flows. It reflects the return investors want to see on instruments with similar risk characteristics, and represents a return on and of capital. It is a blended rate.

Mathematically, the capitalization rate is:

*The rate at which a stream of periodic payments converts to a fixed amount of capital.*

It is expressed as a percentage and is intended to represent overall returns expected by investors from a particular property. When divided into a property NOI, the cap rate will provide a value estimate. Alternatively the cap rate can be determined (extrapolated) by dividing the cash flow stream of an asset (e.g., NOI) by its purchase price.

Here’s a look at the basic concept using two simple examples.

**Scenario A**

You estimate a property, or any other investment, will generate $10M per year on a fairly reliable basis. The asset is being offered at a price of $100M. If you pay full price for this asset, you are implying that the risk profile of the asset (investment) should entitle you to a 10% return on the dollars you have invested. The 10% is the capitalization rate.

**Scenario B**

Alternatively, you determine that you are only willing to pay $83M for the same asset. This implies that you are requiring a higher rate of return on your invested dollars. This could be because you perceive the risk associated with the cash flow stream is higher, or because you have other attractive investment opportunities that make the 10% return offered by the seller look rather unappealing. Regardless of your rationale, if you were able to purchase this asset for $83M, your rate of return (capitalization rate) would be 12%.

<table>
<thead>
<tr>
<th></th>
<th>Scenario A</th>
<th>Scenario B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Cash Flow</td>
<td>$10M</td>
<td>$10M</td>
</tr>
<tr>
<td>Divided by Purchase Price</td>
<td>$100M</td>
<td>$83M</td>
</tr>
<tr>
<td>Equal to Capitalization Rate</td>
<td>10%</td>
<td>$12%</td>
</tr>
</tbody>
</table>
Capitalization Rate Dynamics

As shown above, the higher the capitalization rate, the lower the arithmetic value that is calculated, thus there is an inverse relationship between cap rates and value. This is because when market return expectations (and availability) increase, a static level of cash flow (and profit) will fall short of the new higher expectations, assuming in this case that rental rates are not indexed to interest rates. Thus, these static cash flows are worth comparatively less in the market. The theory is similar in concept to bond theory, in that bond prices fall when interest rates go up, and vice versa.

A capitalization rate reflects a variety of influences, including:

- Risk perception associated with a specific type of property in a specific market.
- Current interest rate environment.
- Return that an investor would expect to receive on a financial instrument with the same risk level as the subject property.

In using the Income Capitalization Approach, **the estimated value of a property is highly sensitive to even nominal changes in cap rates.** Cap rate variations as small as 1/4% to 1/2% can have dramatic effects on property value as shown below. For this reason, the accuracy and validity of the cap rate is critical.

<table>
<thead>
<tr>
<th>NOI</th>
<th>$1,000M</th>
<th>$1,000M</th>
<th>$1,000M</th>
<th>$1,000M</th>
<th>$1,000M</th>
</tr>
</thead>
<tbody>
<tr>
<td>÷ Cap rate</td>
<td>9.5%</td>
<td>9.75%</td>
<td>10%</td>
<td>10.25%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Value</td>
<td>$10,526M</td>
<td>$10,256M</td>
<td>$10,000M</td>
<td>$9,756M</td>
<td>$9,523M</td>
</tr>
</tbody>
</table>

**DERIVING THE CAPITALIZATION RATE**

There is quite a science behind determination of capitalization rates and, unfortunately, “rules of thumb” are not generally accurate. Professional appraisers receive a great deal of training in this area and must consider many factors in arriving at this powerful variable. This gives rise to two basic approaches to formulating the cap rate. One is theoretical, and the other approach is practical.
THE THEORETICAL DERIVATION

Theoretically, cap rates are derived from application of the Band of Investment Technique. The basic premise of the theory is that an investor's target return will be a function of the weighted average cost of capital. For example, if an investor seeks a 10% return on equity on an investment that will be 30% equity funded and 70% debt funded at 8.25%, the weighted average cost of capital is 8.775%, as shown:

<table>
<thead>
<tr>
<th>Percentage of cost funded by:</th>
<th>Return</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>30%</td>
<td>10%</td>
</tr>
<tr>
<td>Debt</td>
<td>70%</td>
<td>8.25% (interest)</td>
</tr>
<tr>
<td>Weighted Average</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

When applied to cap rates, this weighted average calculation will include not only the direct borrowing cost (interest, or return on capital) but also the return of capital to the lender (the debt amortization). The calculation of the cap rate will therefore use a loan constant rather than an interest rate. Here’s an example:

Assume a real estate investment property will be funded with 70% debt and 30% equity as shown above. Assume further that:

The loan will bear interest at a rate of 8.25% and have a 20-year amortization, making the loan constant 10.22%

The investor’s expected cash on cash return is 8%

The overall capitalization rate is calculated by weighting the cost of the debt and equity components of the financing and adding them together as shown here:

Adjusting the above calculation for a loan constant of 10.22% (reflecting an 8.25% interest rate and a 20-year amortization) would result in a cap rate of 10.15% as follows:

<table>
<thead>
<tr>
<th>Percentage of Cost Funded by:</th>
<th>Return</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>30%</td>
<td>10%</td>
</tr>
<tr>
<td>Debt</td>
<td>70%</td>
<td>10.22% (Constant)</td>
</tr>
<tr>
<td>Overall Cap Rate</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The overall cap rate is often rounded to the nearest tenth, or in this case **10.2%**.
Because information regarding investor target risk returns and cost of capital is not widely distributed, or reliable, the more popular and practical derivation of the cap rates follows a different approach: Market Extraction.

Market extraction is the primary method used by appraisers to determine capitalization rates. Using market extraction, the appraiser examines the overall rates of return (often called OAR) implied by sales of comparable income properties. The OAR is determined by dividing the net operating income of a sold property by the property’s sale price. This figure represents the pretax un-leveraged return on investment that the purchaser of the comparable property will realize. The Scenario A and B examples above illustrate this capitalization rate technique.

The cap rate for the subject property is then derived by correlating the data from the comparables with the data from the property being appraised. This process is called “market extraction.”

Although the appraiser may base the subject property’s capitalization rate substantially on the extracted OARs, other capitalization rate considerations are also included in the analysis.
Discounted Cash Flow Analysis

Concept of the Discounted Cash Flow Analysis

Discounted cash flow analysis is a method of capitalizing income property cash flow; that is, using the estimated property cash flow (NOI) to determine the value of the property by applying an expected rate of return to that cash flow stream. It is similar to and builds on or refines the analysis provided in the income capitalization approach and should provide a like valuation, albeit more precise and revealing with respect to the property’s risk profile in future periods.

The income capitalization approach calculates the value of an income property based on current rental rates, vacancy factors, and expenses. The discounted cash flow analysis (DCF) capitalizes the expected cash flow profile of the property for the expected holding period of the owner of the property. It then discounts the future property cash flows and the estimated proceeds from an assumed future sale of the property at the end of the holding period, to arrive at an estimate of the present value of this cash flow stream (i.e., the value as determined by the DCF analysis).

The Process for the Discounted Cash Flow Analysis

The DCF calculates the net operating income for each year of the analysis and based on the discount rate selected, calculates and sums the net present value of each year’s cash flow. The discounted present value of the property’s expected selling price at the end of the holding period, minus expected sales commissions and expenses, is added to this value.

The appraiser executes five basic steps in completing the discounted cash flow analysis. They are outlined here and illustrated in the discounted cash flow example.

- Estimate the net operating income (NOI) for each year in an assumed holding period giving specific consideration to existing lease terms and re-leasing expenses such as rent loss, tenant improvements, and leasing commissions. This period is typically 5 to 10 years.
- Calculate the present value of the annual cash flows for the holding period at an estimated Discount Rate.
- Calculate the reversion value of the property using an assumed capitalization rate. The reversion value is the estimated value of the property at the end of the holding period. The analysis assumes a hypothetical sale of the property at that time.
- Deduct estimated disposition cost to calculate net reversion cash flow at the end of the holding period.
- Calculate the present value of the reversion cash flow at an assumed discount rate and add that present value to the present value of the cash flow stream during the holding period to get the discounted cash flow value.

Note: The DCF is a complex set of calculations normally executed on a spreadsheet program. There are several packaged programs available to the real estate industry from various software vendors. Most DCF programs can calculate a range of values based on a range of discount rates as well as differing cap rates. The chart below illustrates the varied valuation results produced by even subtle changes in these two key variables.
BENEFITS OF USING DISCOUNTED CASH FLOW ANALYSIS

**DCF directly factors in varied inflation rates.** In a DCF, for each year of the analysis, an inflation factor is applied to rental rates and operating expenses. This is important in situations where the rental rates and expenses are not expected to increase at the same pace. For example, if expenses are expected to increase faster than rental rates, an inflation rate of 2% might be assigned to rents and a 4% inflation rate assigned to expenses.

This flexibility is also important in situations where rents are expected to remain flat for, say, two years before resuming an upward trajectory. If inflation rates for rent and expenses are expected to increase at roughly the same pace, the value range calculated by the DCF approach is normally similar to the value derived from the Income Capitalization Approach, when calculated in a "direct" fashion. However, DCF analysis will give a more realistic value of the property if a discrepancy or irregular pattern is expected.

**DCF directly factors in tenant rollover expenses.** The DCF allows expenses related to tenant turnover (such as leasing commissions, tenant improvement, or refurbishment expenses) to be assigned to the specific year or years in which they are expected to occur. In the direct capitalization method, an overall average tenant turnover expense is calculated. If these expenses are expected to be significant or are anticipated to occur at several different intervals in the life of the property, the DCF will provide a more accurate valuation and endow the lender with valuable risk focused information, which can be used in structuring the loan.

**DCF captures longer-term variances in lease economics.** If a lease reflects over- or under- market terms later in the lease period, these benefits or concessions can be lost in a direct capitalization approach. For example, in a seven-year lease assume the rent reduces to zero during the last 3 months lease. A DCF approach would appropriately and precisely factor in this future rent reduction.

---

**Sensitivity Table**

<table>
<thead>
<tr>
<th>Cap Rate</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount Rate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10%</td>
<td>$13,750</td>
<td>$12,712</td>
<td>$11,882</td>
</tr>
<tr>
<td>11%</td>
<td>$13,224</td>
<td>$12,232</td>
<td>$11,439</td>
</tr>
<tr>
<td>12%</td>
<td>$12,725</td>
<td>$11,776</td>
<td>$11,018</td>
</tr>
</tbody>
</table>
TIPS FOR REVIEWING THE DISCOUNTED CASH FLOW ANALYSIS

Step One:
As the DCF analysis is based on income capitalization concepts, all review tips for that valuation approach apply. If that analysis is provided separately, you should first determine that the assumptions and support provided in that analysis are reasonable and consistent. Tips for reviewing the income capitalization approach are:

- Carefully review the description and location of each comparable property to determine if it is truly comparable to the subject property.
- Focus on the timing of each comparable and verify that older transactions have been appropriately discounted in the weighting for that factor.
- Examine each adjustment to see that they are reasonable, well supported and consistent. The rents and vacancy rates selected by the appraiser should be well supported by market evidence, and existing or anticipated operating expenses of the building should be compared with those of similar properties and/or to general industry expense figures.
- Review the assumptions used in assigning the capitalization rate.

Step Two:
Determine if the appraiser has fully discussed and supported the additional variables and assumptions, such as inflation rates and discount rates, used in the DCF calculation. These assumptions should be well supported and the source of the data used in making these assumptions should be fully disclosed. Several national and regional data sources regularly compile information about discount rates, expense rates, etc., that institutional investors and underwriters use for various property types. A knowledgeable appraiser or broker in the local market area can suggest the appropriate sources and help lenders obtain them.

DISCOUNTED CASH FLOW EXAMPLE
The following is an example of a DCF valuation for a simple apartment property. Note: This illustration can also be solved on a financial calculator, although answers may vary because of rounding.

Assume:

- A 5 year holding period for an income property
- Annual NOI of $1,102M in the first year
- NOI increases by 3% per year
- Reversionary capitalization rate is 9%
- Discount rate is 12%
Step 1: Estimate the net operating income (NOI) for each year in the assumed holding period, giving specific consideration to existing lease terms and re-leasing expenses such as rent loss, tenant improvements, and leasing commissions. In this case an apartment property is showcased, so the re-tenanting and leasing costs are smoothed. In a multi-tenanted retail or office property this would likely not be the case.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base Rents</td>
<td>$1,818</td>
<td>$1,873</td>
<td>$1,929</td>
<td>$1,987</td>
</tr>
<tr>
<td>Vacancy (5%)</td>
<td>-$91</td>
<td>-$94</td>
<td>-$96</td>
<td>-$99</td>
</tr>
<tr>
<td>Adjusted Gross Income</td>
<td>$1,727</td>
<td>$1,779</td>
<td>$1,832</td>
<td>$1,887</td>
</tr>
<tr>
<td>Misc. Income (laundry)</td>
<td>$39</td>
<td>$40</td>
<td>$41</td>
<td>$43</td>
</tr>
<tr>
<td>Effective Gross Income</td>
<td>$1,766</td>
<td>$1,819</td>
<td>$1,874</td>
<td>$1,930</td>
</tr>
</tbody>
</table>

Less Expenses
- Taxes: -182, -187, -193, -199, -205
- Insurance: -23, -24, -24, -25, -26
- Utilities: -109, -112, -116, -119, -123
- G&A: -88, -91, -93, -96, -99
- Mgmt Fees: -54, -56, -57, -59, -61
- Salaries: -71, -73, -75, -78, -80
- Advertising: -15, -15, -16, -16, -17
- Maintenance and Repairs: -101, -104, -107, -110, -114
- Reserves: -21, -22, -22, -23, -24

Total Expenses: -$664, -$684, -$704, -$726, -$747
Net Operating Income: $1,102, $1,135, $1,169, $1,204, $1,240

Step 2: Calculate the present value of the annual cash flows for the holding period at an estimated discount rate.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI</td>
<td>$1,102</td>
<td>$1,135</td>
<td>$1,169</td>
<td>$1,204</td>
</tr>
<tr>
<td>Discount Rate</td>
<td>12%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Present Value of NOIs</td>
<td>$4,299</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Step 3: Calculate the reversion value of the property using an assumed capitalization rate. The reversion value is the estimated value of property at the end of the holding period. The analysis assumes a hypothetical sale of the property at that time.

- NOI year 5: $1,240M
- Capitalization Rate: 9%
- Reversion Value: $13,782M

Step 4: Deduct estimated disposition cost to calculate net reversion cash flow at the end of the holding period.

- Reversion Value: $13,782M
- Disposition Cost: $413M
- Reversion Cash Flow: $13,369M

Step 5: Calculate the present value of the reversion at an assumed discount rate and add that present value to the present value of the cash flow stream during the holding period to get the discounted cash flow value.

- Present Value of Reversion Cash Flow: $7,934M
- Present Value of Annual Cash Flow: $4,299M
- Discounted Cash Flow Value: $12,233M
**Final Reconciliation of Value**

The final reconciliation of value is the appraiser’s overall assessment of value, taking into consideration findings from each analytical technique used during the appraisal process.

Most commercial properties are appraised using three separate approaches to value.

1. **Cost**
2. **Sales Comparison, or Market**
3. **Income Capitalization**

The appraiser must weigh the values calculated from each approach and correlate a final value for the property.

**WEIGHTING THE VALUES**

The values derived from each approach may differ significantly. However, while the temptation may be to merely average the values from the three approaches, the standards of appraisal practice require that a professional appraiser use his or her professional judgment to determine the approach or approaches to value that are most applicable to valuation of the subject property.

The appraiser should list the values derived from each approach and discuss the reasoning for the choice of values having the most bearing on the final property value determined.

Since each commercial property possesses its own set of unique characteristics and circumstances, there are no rules as to which value merits the most emphasis for specific types of property. However, for most income producing property, the income capitalization/cash flow approach should figure prominently in the appraiser’s correlation of final value. In an owner-occupant transaction, the sales comparison (market) approach typically carries the most weight.

**REVIEWING THE FINAL RECONCILIATION OF VALUE**

When reviewing the final reconciliation of value, you should carefully examine the appraiser’s reasoning in the final correlation to determine if it is well supported and appropriate. If the appraisal has not logically led you to the same conclusion as presented, you should follow up with the appraiser to gain more insight. Alternatively, you may wish to have the appraisal reviewed by a more experienced real estate lender for another opinion on the reliability of the value estimate. For significant credits, you may want to order an independent appraisal review.

Appraisals should be scrutinized just as if they were a company’s financial statements. You would never make a business loan without closely reviewing a balance sheet, income statement, and cash flow statement. Appraisals should be treated no differently in the underwriting process. The arguments presented in the appraisal should be consistent and well supported.
Appraisal Review Tips

The content of an appraisal can be daunting, especially to the novice. In addition to knowing what to look for, it is useful to know where to look. These few tips are intended to expedite your preliminary review of the appraisal. Of course, you should thoroughly review the full appraisal prior to committing bank resources.

Conclusions can be found at the front of the report and at the end of each section. Take the time to carefully read the conditions set forth regarding each statement of value. For example, *value as is* and *value at stabilization* are likely not the same. Consider whether sufficient funds/resources are available to reach the value to which the loan is being underwritten.

Tables efficiently display a significant amount of detail, which is also articulated in the text. Using the tables will help you focus on the specifics of the comparable properties discussed in the appraisal.

**Highest and Best Use** section should be checked for surprises. This section usually indicates the highest and best use of the real estate is “as developed” or “as proposed.” If it doesn’t, there is likely some economic or functional obsolescence that should be factored into the credit decision.

**Final Reconciliation of Value** should be checked for the weighting arguments relating to the three approaches to value: cost approach, sales comparison (market) approach and income capitalization (or cash flow) approach. Ask, “Does the reconciliation make sense?”

Consistent Arguments should be presented throughout the appraisal. Do not hesitate to discuss any questions you have with the appraiser. They are only human. They can and do make mistakes from time to time. In addition, note that you are responsible for articulating and defending the appraiser’s findings to your client. Your solid understanding of the appraiser’s rationale is therefore a necessity.

**Site Visit** – Finally, there is no substitute for seeing the property with your own eyes. You, or your agent, should physically inspect the site/property prior to, or in conjunction with, the appraisal review. If this is not possible, at a minimum you or your agent should physically inspect the site/property prior to committing the financing.

Appraisal Review Forms

The use of an appraisal review check sheet will assist and expedite your review process, and foster consistency in your focus. There are three forms provided to specifically aid you in assessing appraisal standards conformance, content, and conclusions. The forms are:

1. Commercial Administrative Review Form
2. Commercial Appraisal Underwriting Form
3. Business Line Residential Appraisal Review Form
## COMMERCIAL ADMINISTRATIVE REVIEW FORM

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Loan Officer</th>
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<table>
<thead>
<tr>
<th>Property Address</th>
<th>Report Date</th>
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<thead>
<tr>
<th>Effective Dates</th>
<th>Value Estimates</th>
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<table>
<thead>
<tr>
<th>Appraiser/Firm</th>
<th>Property Type</th>
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### Attach Explanation for Any “No” Responses that Affect Value

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
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</table>

### Appraisal Standard Rules

- (a) Conforms to **Canadian Uniform Standards of Professional Appraisal Practice Canadian USPAP**
- (b) Written and contains sufficient information and analysis to support business decision
- (c) Analyzes and reports appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units
- (d) Based on definition of market value in Canadian USPAP and Bank Instructions
- (e) Performed by State licensed or certified appraiser as required

**Canadian USPAP Reporting Requirements**

- Report Type: Self-Contained [ ] Summary [ ] Consistent with Bank Retention Letter:
- Key Words: Self-Contained = Describe Summary = Summarize (option stated in parentheses)
  - i. Identify and describe (or provide summary description of) the real estate
  - ii. State real property interest [fee simple, leased fee, leasehold, etc.]
  - iii. State purpose and intended use of appraisal
  - iv. Define the value to be estimated [see Item d above]
  - v. State effective date of appraisal and date of report [transmittal date]
  - vi. State (or summarize) the extent of the process of collecting, confirming, reporting data
  - vii. State all assumptions and limiting conditions that affect the appraisal
  - viii. Describe (or summarize) the information considered, the appraisal procedures followed and reasoning that supports the analyses, opinions, and conclusions.
  - ix. Describe (or summarize) the opinion of highest and best use [when appropriate]
  - x. Explain and support the exclusion of any of the usual valuation approaches
  - xi. Describe (or summarize) any additional information appropriate to show compliance with the specific guidelines of Standard 1 [or explain permitted departures]
  - xii. Include a signed certification in accordance with Canadian USPAP Reporting Requirements.

### Content Issues

- Significant mathematical calculations presented clearly and accurately
- Report sections are consistent and reconcile without contradicting information
- Value conclusion reconciles with value range from approaches used and is logical

### REVIEWER CONCLUSIONS

- Appraisal Acceptable as Submitted
- If no: attach rationale or comment on reverse
- Appraisal Acceptable after Correction/Resubmission by Appraiser
- If yes: attach letter transmitting appraisal and reviewer comments to appraiser

<table>
<thead>
<tr>
<th>Reviewer Signature</th>
<th>Date of Review</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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</tbody>
</table>

Attachment: Yes [ ] # of Pages [ ] No [ ] Commercial Appraisal Underwriting Form

[ ] BANK
<table>
<thead>
<tr>
<th>Borrower</th>
<th>Loan Officer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Address</td>
<td>Report Date</td>
</tr>
<tr>
<td>Effective Dates</td>
<td></td>
</tr>
<tr>
<td>Appraiser/Firm</td>
<td>Property Type</td>
</tr>
<tr>
<td>Exposure Time Associated with Value Estimate</td>
<td></td>
</tr>
<tr>
<td>Environmental Issues Identified in Appraisal</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>Property Rights Appraised</td>
<td></td>
</tr>
<tr>
<td>- Same as Borrower Interest in Property</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>Economic Characteristics Match Market Perspectives of Bank</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>Neighborhood Characteristics Consistent with Use of Property</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>Zoning Allows Present Use of Property</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- If no: Can improvements be re-constructed if damaged</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>Size of Site:</td>
<td>Land/Bldg Ratio</td>
</tr>
<tr>
<td>Size of Buildings:</td>
<td>No. of Buildings:</td>
</tr>
<tr>
<td>- Site shape/topography suited to present use</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- Excess land for present use</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- Building repairs required</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- Building occupancy</td>
<td></td>
</tr>
<tr>
<td>Highest and Best Use</td>
<td></td>
</tr>
<tr>
<td>- Consistent with present use</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- If vacant land, when can development potential be realized</td>
<td></td>
</tr>
<tr>
<td>Cost Approach Developed:</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- Site Value Contribution</td>
<td></td>
</tr>
<tr>
<td>- Indicated Value</td>
<td></td>
</tr>
<tr>
<td>Sales Comparison Approach Developed:</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>No. of Sales:</td>
<td>Unadjusted Range in Unit Sale Prices</td>
</tr>
<tr>
<td>- Do sales compete with subject (similar size, type, location)</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- Adjusted Range in Unit Values</td>
<td></td>
</tr>
<tr>
<td>- Indicated Value</td>
<td></td>
</tr>
<tr>
<td>Income Capitalization Approach Developed:</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>- Estimate of Market Rent</td>
<td></td>
</tr>
<tr>
<td>- If leased, is Contract Rent at or near Market Rent</td>
<td>Yes [ ] No [ ] N/A [ ]</td>
</tr>
<tr>
<td>- If owner-occupied, can Borrower afford to rent own building</td>
<td>Yes [ ] No [ ] N/A [ ]</td>
</tr>
<tr>
<td>Direct Capitalization and DCF Analysis (Upon Stabilization)</td>
<td>DCF Analysis (On Completion)</td>
</tr>
<tr>
<td>Effective Gross Income (EGI):</td>
<td>Year 1 EGI:</td>
</tr>
<tr>
<td>Operating Expenses:</td>
<td>Year 1 Exp:</td>
</tr>
<tr>
<td>Net Operating Income (NOI):</td>
<td>Year 1 NOI: %</td>
</tr>
<tr>
<td>Overall Cap Rate:</td>
<td>Discount Rate:</td>
</tr>
<tr>
<td>Indicated Value:</td>
<td>Terminal (Reversion) Cap Rate:</td>
</tr>
<tr>
<td>DCF Analysis Year 1 Cash Flow:</td>
<td>Indicated Value:</td>
</tr>
<tr>
<td>Indicated Value:</td>
<td>Implied Year 1 Cap Rate:</td>
</tr>
<tr>
<td>- Is/are capitalization rate(s) consistent with loan rate structure</td>
<td>Yes [ ] No [ ]</td>
</tr>
<tr>
<td>Final Estimates of Value:</td>
<td></td>
</tr>
<tr>
<td>Attachment: Yes [ ] # of Pages [ ] No [ ]</td>
<td></td>
</tr>
</tbody>
</table>
# BANK: BUSINESS LINE RESIDENTIAL APPRAISAL REVIEW FORM

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Officer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Address</td>
<td>Report Date</td>
</tr>
<tr>
<td></td>
<td>Effective Date</td>
</tr>
<tr>
<td></td>
<td>Value Estimate</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Appraiser/Firm</th>
<th>Property Type</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1-Family Condo</td>
</tr>
<tr>
<td></td>
<td>2-4 Family</td>
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</tbody>
</table>

NOTE: Attach Explanation for any No and/or ? Responses

<table>
<thead>
<tr>
<th>Content Issues</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. a) Correct form report used for property type being appraised?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b) SUBJECT section of form completed in full?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. NEIGHBORHOOD location, analysis, land uses, changes, occupancy complete?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Are comments descriptive, informative, pertinent, conclusive?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. SITE DESCRIPTION complete?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Zoning identified and conformity/compliance stated?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b) FEMA Flood Hazard information completed?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c) Highest and Best Use same as present use or explained if different?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. IMPROVEMENTS description, exterior/interior, complete and acceptable?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Age and effective age estimate appear reasonable?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b) Do comments address:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Additional features, repairs required, modernization?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ii. Physical, functional, external adequacies/inadequacies?</td>
<td></td>
<td></td>
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<tr>
<td>iii. General market conditions?</td>
<td></td>
<td></td>
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<tr>
<td>5. COST APPROACH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Building sketch calculations shown?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b) Same gross living area (sq.ft. living area) used throughout report?</td>
<td></td>
<td></td>
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<tr>
<td>c) Do cost calculations appear reasonable and are they mathematically accurate?</td>
<td></td>
<td></td>
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<tr>
<td>d) Are depreciation factors consistent with improvement descriptions?</td>
<td></td>
<td></td>
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<tr>
<td>6. SALES COMPARISON APPROACH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Are comparables recent and similar to subject in location, site size, improvement size/room count, amenities, etc. or are differences adequately explained?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b) Are adjustments reasonable, logical, consistent and mathematically accurate?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c) Are individual adjustments under 10% of comparable sale price or explained if over?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d) Are net adjustments under 15% of comparable sale price or explained if over?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e) Are gross adjustments under 25% of comparable sale price or explained if over?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>f) Do comments explain atypical adjustments, add additional information, and/or clarify analysis as/if needed?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. INCOME APPROACH Applicable</td>
<td>Not Applicable</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. RECONCILIATION discusses approaches to value and provides supported conclusion?</td>
<td></td>
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</tr>
<tr>
<td>9. Is the Estimate of Market Value stated with an appropriate effective (as of) date?</td>
<td></td>
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</tr>
<tr>
<td>a) Is value within price range of Neighborhood as stated in report?</td>
<td></td>
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</tr>
<tr>
<td>10. Addendum include photographs of subject and comparable sales; interior sketch of subject with exterior dimensions; map locating subject and comparable sales; correct Definition of Market Value; signed and dated Certification and Statement of Limiting Conditions?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Appraisal Acceptable as Submitted

Appraisal Rejected (attach list of reasons for rejection)

Reviewer Signature
Reviewer Name

Date of Review
Dimension 6:
Identify Repayment Sources and Appropriately Structure and Document Credit Exposures or their Intended Purpose (Loan Structure and Documentation)
Purpose of Dimension 6

Dimension 6 focuses on appropriately structuring and documenting credit with respect to the identified repayment sources. In Dimension 6 we will cover the following topics:

1. Identifying primary and secondary sources of repayment and financing
2. Determining the loan structure, including loan support and covenants
3. Documenting the credit, including perfecting liens and documenting third party support
4. Regulatory compliance
5. Loan closing procedures
6. Identifying and mitigating environmental risk
IDENTIFYING PRIMARY AND SECONDARY SOURCES OF REPAYMENT AND FINANCING

Interviewing the Borrower about Expected Borrowing Needs and Resources

The first step in identifying sources of repayment is to ask the borrower about expected needs and resources. Questions to ask during the loan interview include:

- **Primary sources**
  - How does the borrower expect to obtain funds for repayment?
  - What are the present main sources of financing? Banks? Suppliers?

- **Additional sources**
  - What other sources of repayment are available? Other financing? Sale of fixed assets?
  - What are the secondary sources of financing? Sale of equity? Conversion to other types of debt?
  - Are finance companies or factors used for funds?
  - Do principals, relatives, friends, customers, or suppliers advance funds to the company?
  - What is the nature and extent of these loans?

- **Suppliers**
  - Who are the major suppliers?
  - What are the regular trade terms offered to the company?
  - How good is their current relationship?
  - Are discounts taken? Are payments prompt?
  - Are any items currently in dispute or litigation?
  - Are any special terms or relationships involved?
  - Are any transactions with or through closely affiliated or mutually controlled enterprises?
  - Are contracts or franchises involved? What are the details of these relationships?

For additional review of identifying repayment sources, see *Dimension 4*, which discusses performing cash flow assessments. Also see *Dimension 3*, which reviews financial analysis tools and includes discussion of assessing the quality of earnings and assets.

**Performing Your Own Assessment of Primary Repayment Sources**

Next, perform your own assessment of primary repayment sources. Recall from your reading in Dimension 4 that there are five principal borrowing causes. Each of these causes also suggests a repayment source if the underlying cause reverses:
• **Borrowing Cause**: current asset growth resulting from sales growth, both seasonal and permanent.
  
  **Repayment Source**: liquidation of current assets when a seasonal asset build-up reverses itself as the seasonal operating cycle is completed, or when longer-term growth stops or reverses.
  
  Current asset liquidation through a seasonal operating cycle is a very high quality source of repayment as it stems directly from company operations and demonstrates the company’s seasonal asset buildup is temporary. Current asset liquidation from curtailing longer-term growth, or when sales recede, is a non-renewable source of cash flow that may also signal difficulties within the company’s business model.

• **Borrowing Cause**: current asset growth resulting from declining efficiency.
  
  **Repayment Source**: current asset reduction resulting from improved efficiency.
  
  A reduction in the cash cycle reduces the cash investment in current assets. Cash released through efficiency improvement is a quality source of repayment, although it may not be a repeatable source of repayment. For example, a company that improved its cash cycle by eliminating ten days from its collection period is not likely to be able to achieve a comparable improvement in subsequent years.

• **Borrowing Cause**: fixed asset expenditures.
  
  **Repayment Source**: sale of assets.
  
  Keep in mind that sale of assets is usually not a high quality repayment source, as asset sales are generally infrequent and/or non repeatable. An asset sale may produce desirable cash inflows, but these should generally be considered as one-time sources that are not presumed to be available for future debt service.

• **Borrowing Cause**: reduction in trade credit.
  
  **Repayment Source**: increase in trade credit availability.
  
  When suppliers provide additional financing, the cash cycle decreases and fewer current assets need to be supported by external sources. Trade credit increases are quality sources of repayment, with the significant qualification that they are generally non-repeatable sources of new cash.

• **Borrowing Cause**: decreases in net worth, including the result of unprofitable operations or the payment of dividends.
  
  **Repayment Source**: net worth infusions from owners or new investors; change of policy to retain earnings instead of paying dividends; profitability improvement.
  
  Outside capital supplied to the business is a valuable potential source of repayment, but absent a contractual agreement it is difficult to compel future capital contributions and thus new capital as a prospective repayment source is neither predictable nor dependable. Minimum net worth requirements enforced through loan agreements can encourage earnings creation and retention, but keep in mind that although retained profit makes a stronger borrower, profits themselves do not necessarily correlate to cash flow.
  
  It is important to view fundamental profitability as a long-term driver of ability to repay debt, but the more useful measure of quality sources of repayment lies in analyzing the
cash flow statement. Earnings retained in a business can contribute to long-term cash flow available to service long-term debt, but short-term operating needs must be satisfied first.

Other borrowing causes can include outlays for other asset acquisition (such as investments), and restructuring current or long-term liabilities. Of course, investment sales, or liability restructurings that introduce new capital can provide repayment sources.

To refresh your understanding of how to identify primary repayment sources, please review Dimension 4, which discusses performing cash flow assessments. In Dimension 4, you learn to use cash cycle analysis, cash flow statement analysis and projections to identify both primary borrowing causes and repayment sources. Also see Dimension 3, which reviews financial analysis tools and includes discussion of assessing the quality of earnings and assets.

**Identifying Secondary and Tertiary Repayment Sources**

After you have identified potential primary repayment sources, and after you have compared your analysis with the borrower’s view of repayment source, evaluate potential secondary and tertiary sources. These will become key determinants of your loan structure (loan structure concepts are covered later in this Dimension).

Secondary and tertiary repayment sources include:

- **Liquidation of collateral**
  
  Sale, conversion or liquidation of assets is often a primary source of repayment, as in the liquidation of current assets to repay a seasonal line of credit. If asset conversion is a primary repayment source, consider securing the loan to ensure the bank will have access to these assets to enforce collection of the primary source. If asset conversion is not a primary repayment source (such as for a term loan made to finance a capital asset), consider securing the loan to ensure access to a secondary source of repayment. If primary or other secondary repayment sources are uncertain or subject to interruption, consider securing the loan to provide both enforcement, access and control of assets as a secondary or tertiary repayment source.

  To help you qualify assets as potential collateral for the loan, see Dimension 5, which provides detailed analysis of collateral value and limitations for these types of assets:

  - Securities and Investments
  - Accounts and Notes Receivable
  - Inventory
  - Plant and Equipment
  - Real Estate
  - Intangible Assets, including intellectual property

- **Performance of guarantees and other third party support**
If your borrower is a closely-held entity, and/or if the borrower’s legal form of organization features limited liability, there may be a compelling reason to require personal and/or corporate guarantees or other forms of third party support. Growing private companies may be thinly capitalized; owners of closely held companies may need or prefer to remove earnings from the company; and companies that are part of closely held groups may easily transfer assets and repayment sources between related entities.

Third party support for loans may include:
- Personal guarantees
- Corporate guarantees
- Subordination agreements
- Comfort letters
- Letters of credit

The effectiveness of each of these secondary/tertiary repayment sources may be limited by three factors: value, willingness, and enforceability. For example, the value of a personal or corporate guarantee is limited to the underlying resources provided by the guarantor. For the repayment source to be meaningful, you should assess the guarantor’s current and probable future financial resources. For a corporate guarantor, perform a credit analysis using tools provided in Dimensions 1 through 4. For an individual guarantor, assess personal financial statements and liquidity using techniques presented in Dimension 3.

Evaluate the ‘willingness’ factor for potential guarantors or issuers of comfort letters, including individuals, affiliated entities or other credit sponsors. Look for clues to suggest whether prior commitments have been honored, or whether there has been litigation to try to avoid honoring a contingent commitment. Determine if the guarantor has a financial or emotional stake in the success of the company whose obligations are being guaranteed.

To evaluate enforceability, make sure that you have documents that require a full, unconditional guarantee, and ensure that the structure of the transaction will stand up to legal challenges from company creditors or other parties. For detailed explanations of structuring third party support effectively, see Loan Support and Covenants, and Documenting the Loan later in this Dimension.

- Non-operating resources

If you have identified operating sources of cash as the primary repayment source for a loan, it may be appropriate to consider additional resources analyzed earlier as a secondary repayment source. For example, there may be potential for additional capital from shareholders, or for a refinancing of an asset with a private lender. Bear in mind that absent enforceable contracts or agreements to compel this eventual source of repayment, the value of these resources is limited.
Determining the Loan Structure

Once you have identified the underlying borrowing cause(s) and understand both primary and secondary repayment sources available, the next step is to structure the loan.

Loan structure depends on the nature of your customer’s business and how your institution intends to provide financial services to the company. To properly structure a customer relationship, you must be able to:

- Project how the company will perform in the future, including likely primary and secondary repayment sources.
- Anticipate challenges and problems that may arise.
- Match an appropriate type of loan to both the loan purpose and the likely repayment sources.
- Develop a set of covenants that protects your institution for the duration of the relationship.

Loan structure is important to the customer because they need to clearly understand the boundaries within which they can operate and continue to depend upon your institution for their financial services needs. The structure of the deal appropriately establishes your customer’s expectations for how your institution will perform during the term of the relationship. They need this assurance in order to run their business efficiently; i.e., if they operate in accordance with the terms and conditions of the loan agreement, your customer can expect funding from your institution.

By having an appropriate structure to the relationship, agreeable to both parties, you have established a mechanism for monitoring individual transactions within a relationship. This monitoring process can be accomplished in two ways:

- Have a loan covenant checklist that routinely tracks your customer’s adherence to covenants.
- Require that an officer of the company regularly (quarterly, for example) certify as to the company’s compliance with all of its outstanding agreements.

Failing to give notice to your customer of a covenant default may make your institution’s future enforcement of the covenant difficult.

This section of Dimension 6 provides you with an overview of various products, services, and tools to structure a transaction. We will profile common credit facilities and specialized products that are available to meet your customer’s borrowing needs, given the identified repayment sources. For each credit facility and specialized product profiled, you will learn to:

- Match structure with loan purpose.
- Identify sources of repayment that are appropriate for the facility or specialized product.
- Determine collateral appropriate for the facility or specialized product.
- Identify and understand how to mitigate risks associated with the facility or specialized product.
CREDIT FACILITIES

The purpose of this section is to provide an overview and understanding of the application of each of the following financing mechanisms:

- Seasonal Line of Credit, or Operating Line of Credit
- Revolving Line of Credit, or Revolving Term Loan
- Term Loans
- Leases
- Bridge Loans
- Mortgage Financing
- Special Programs

Although these products are commonly used today, it is helpful to ensure that you have mastered the applicability of each of these structuring considerations.

In addition, we explore the following funding facilities:

- Subordinated Debt
- Private Placements
- Loan Syndications
- High Yield Debt
- Commercial Paper

These products are an introduction to less traditional financing options. In the past, these products were only available to the largest, most creditworthy companies. As “Main Street” continues its convergence with "Wall Street," smaller companies will have greater access to these products.

Although your institution may not offer these products today, it is important for you to have knowledge of their application. In your role in the customer relationship, you may find ways to provide these products to your customers through strategic alliances with other financial institutions, while at the same time maintaining control of the overall customer relationship.

Seasonal Line of Credit or Operating Line of Credit

**General Features**

A seasonal line of credit or operating line of credit is a short-term loan, usually less than one year, used to finance inventory and/or accounts receivable for a company with a seasonal financing need. The loan is handled under a committed or demand line of credit set at a limit that allows for peak borrowing and structures repayment with the low point in the seasonal cycle. Depending on the length of the cycle, there may be a clean-up or clean-down period, when the company is required to be free of debt for at least 30 days each year to prove their borrowings are seasonal and not required as permanent working capital.
There are two types of Season Lines of Credit:

- **Demand Line of Credit** is established for a specified period of time and expresses your intention to extend credit as required by the borrower, but are subject to demand, or a request for repayment at the discretion of the lending institution. These are commonly referred to as demand lines of credit. The documentation must clearly stipulate that the loans are “payable on demand” and the loan will be evidenced by a demand promissory note (in addition to any other required documentation and security such as a loan agreement and supporting security documentation). Legal precedence is quite clear, however, that you must provide the client with reasonable notice when demanding loans.

- **Committed Line of Credit** is an arrangement evidenced by a written agreement signed by you and the borrower in which you commit to advance funds on specific terms at their request. Typically, the loan cannot be “demanded” unless the borrower fails to comply with one or more terms or conditions under the written agreement. The failure to comply with a term or condition is generally referred to as a Default or an Event of Default.

**Purpose**

The principal purpose of the proceeds is to finance the cash cycle, i.e., payment of operating costs, the purchase of inventory, financing of accounts receivable, and the ultimate payment of the suppliers. Determining the high and low point borrowing periods is key to structuring the loan.

**Collateral Considerations**

The credit may be secured by a perfected security interest in accounts receivable and inventory, at a minimum, and plant and equipment, at a maximum. This requirement may not be necessary with larger, well-established companies with strong capital bases and credit ratings, and no other liens attached to its assets. Creating advance rates for accounts receivable (usually 75-80%) and inventory (10-50%, depending on whether it is raw materials or finished goods and 0 – 10% for work in process) against which to lend may be possible to ensure good working capital management.

**Sources of Repayment**

The sources of repayment for seasonal lines of credit are:

- Contraction of current assets, specifically accounts receivable and inventory.
- Conversion to long-term debt.
- Liquidation of assets.
- Additional equity.

**Key Risks**

The key risks for seasonal loans are as follows:

- Will the season happen?
- Are the proceeds being used for the purpose for which they are intended?
• Has the bank provided sufficient funds in the event sales outpace projections, requiring an additional back up of inventory and accounts receivables?
• Are there significant risks associated with the assets being financed?
• Are the assets easily converted to cash?

These risks are mitigated by:
• Careful monitoring of loan proceeds to ensure funds are being used as agreed.
• Evaluating and monitoring assets to maintain liquidation value.
• Ensuring maintenance of trade credit between the company and suppliers.

Revolving Lines of Credit, or Revolving Term Loans

General Features
A revolving line of credit or a revolving term loan (revolver) is a contractual agreement whereby the bank agrees to make loans up to a specified maximum for a specified period, usually a year or more. As the company repays a portion of the loan, an amount equal to the repayment can be borrowed again under the terms of the agreement. In addition to interest borne by notes, the bank charges a commitment fee to hold the funds available on the unused portion. Often, advance rates for accounts receivable and/or inventory are structured with the facility. Revolving lines of credit with advance rates and liens on current assets are also referred to as Asset-Based Lending in some financial institutions.

There are two types of lines of credit:
• **Unadvised Credit Line or Guidance Line** is created when you obtain approval for a loan amount greater than the amount requested because you anticipate that the client will have a financial need in the near future. No "commitment" or "terms and conditions" letter is sent to the customer.
• **Committed Line of Credit** is an arrangement evidenced by a written agreement signed by you and the borrower in which you commit to advance funds on specific terms at their request. Typically, the loan cannot be "demanded" unless the borrower fails to comply with one or more terms or conditions under the written agreement. The failure to comply with a term or condition is referred to as a Default or an Event of Default.

Purpose
The purpose of the revolver is to finance permanent working capital needs that arise through the continual replacement of accounts receivable and inventory with new accounts receivable and inventory, thus providing a permanent layer of working capital. These financing needs occur in new or expanding companies when growth outstrips the financing generated internally from operating activities or external from debt or equity injections.

Collateral Considerations
The bank may be secured by a perfected security interest in accounts receivable and inventory, at a minimum, and plant and equipment, at a maximum. This requirement may not be necessary with larger, well-established companies with strong capital bases and credit rating, and no other liens attached to its assets. Creating advance rates for accounts
receivable (usually 75-80%) and inventory (0-50%) against which to lend may be possible to ensure good working capital management.

**Sources of Repayment**
The loan is repaid from:

- Earnings and effective conversion and/or contraction of working capital.
- Conversion to term debt.
- Liquidation of assets.
- Additional equity.

**Key Risks**
The key risks associated with revolving lines of credit are:

- The company’s ability to maintain sales, profitable margins, and effective management of working capital.
- The underlying integrity (marketability and liquidity) of accounts receivable and inventory to provide the bank with a secondary source of repayment.
- Unexpected or uncontrolled growth that can result in increased or unexpected incremental financing needs.
- Proceeds may be used for something other than the original loan purpose.

These risks can best be mitigated by:

- Careful monitoring to ensure consistency in use of proceeds with the original loan purpose.
- Effective valuation and monitoring procedures for current assets.

For detailed articles about revolving credits that finance accounts receivable, see the Credit and Lending Studies Pack Accounts Receivable Financing by RMA.

**Term Loans**

**General Features**
Term loans are structured as intermediate to long-term facilities, usually two to ten years. They are generally secured. The loan amount is amortized over a fixed period, sometimes ending with a balloon payment (final payment is substantially larger than preceding payments).

**Loan Purpose**
The funds are used to finance the long-term needs of the company, including acquisitions, purchase of equipment or fixed assets, support increased levels of permanent working capital assets, and to refinance debt or equity.
Collateral Considerations
A first charge or lien on fixed assets or a first or second charge or lien on current assets generally secures term loans.

Sources of Repayment
The possible sources of repayment are:

- Operating cash flows of the company. Although frequently these are equal amortizing payments, this may not be workable in a company that has limited cash flow in the early years of the transaction or that receives cash income in unequal amounts. The term and repayment schedule of the loan must match the business cycle of the company and its ability to generate the cash needed to make the debt payments.

- The liquidation of assets.

- Additional equity.

Key Risks
The key risks in term debt are:

- The company’s ability to maintain sales, profitable margins and effective management of working capital to ensure forecasted cash flow.

- The underlying integrity (marketability and liquidity) of assets to provide the bank with a secondary source of repayment.

The key risk mitigants allow the bank to:

- Only offer facilities that are warranted by the cash flows of the company.

- Access additional equity, if needed.

- Impose a cash flow recapture formula that allows the bank to benefit from prepayment of the loan from excess cash flow generated by the company.

Leases
A lease is a contract granting the use of real estate, equipment or other fixed assets for a specified time in exchange for payment. The various forms of leases are as follows:

- **Financial or Capital Lease**: The service provided by the lessor to the lessee is limited to the financing of the equipment. All other responsibilities related to the possession of equipment such as maintenance, insurance and taxes are borne by the lessee. The lessee acquires essentially all of the economic benefits and risks of the leased property. The lease must be reflected on the company’s balance sheet as an asset with corresponding liability. The lease is usually non-cancelable and is fully paid out over its term.

- **Operating Lease**: Generally involving equipment, this contract is written for considerably less than the life of the equipment and the lessor handles all maintenance and servicing. Most operating leases are cancelable, meaning the lessee can return the equipment if it becomes obsolete or is no longer needed. This form of financing does not appear on the balance sheet of the lessee, but is a contingent liability and should be included in the notes to financial statements.
• **Sale and Leaseback:** In this form of lease arrangement, a company sells an asset to another party in exchange for cash, then contracts to lease the asset for a specified term. A company generally chooses sale and leaseback versus straight mortgage financing when the rate it would have to pay a mortgage lender is higher than the cost of rental or when the company needs to show less debt or fewer assets on its balance sheet.

**Lease Purpose**

The proceeds of a lease are generally used to finance equipment, land and buildings. Today, it is possible to lease virtually any kind of fixed asset. The type of lease chosen will depend on the balance sheet and tax objectives of the firm.

**Collateral Considerations**

As the owner of the asset, the lessor is entitled to take possession of the leased asset in the event of default. If the value of the asset is less than the required payments under the lease, the lessor may be able to enter a claim for payment, depending on the wording in the lease.

**Source of Repayment**

- The repayment structure of a lease is generally linked to the useful life of the asset and the company’s ability to generate those cash flows.
- From the lessor’s perspective, the liquidation of the leased asset is the second way out of the lease.

**Key Risks**

Like term debt, the key risks in a lease are:

- The company’s ability to maintain sales, profitable margins and effective management of working capital to ensure forecasted cash flow.
- The underlying integrity of assets to provide the lessor with a secondary source of repayment.

These risks can be mitigated by:

- Matching the term of lease to the useful life of the asset.
- Continued monitoring of the lessee’s financial position.

**Bridge Loans**

**General Features**

A bridge loan is a short-term loan, also called a swing loan, made in anticipation of intermediate-term or long-term financing, the infusion of equity, or the sale of an asset. Interim interest is charged and the principal is paid at maturity.

**Loan Purpose**

- An acquisition scenario, where part of a business will be sold shortly after being acquired.
• Real estate, construction projects or acquisitions by management and other investors where the company can refinance in the long-term debt market
• A successful project or acquisition where a public offering will be well received by the market

**Collateral Considerations**

The need for collateral may not always be fulfilled, particularly with a financially strong and diversified company. However, in real estate, construction, and leveraged buyout financing, where there remains significant risk, the taking of collateral is essential. In the event that the sale of an asset or the proceeds of refinancing through debt or equity will repay the bridge loan, the lender should ensure control over the proceeds to arrange for immediate receipt.

**Sources of Repayment**

The primary source of payment is an asset sale or refinancing through debt or equity. In addition, a careful analysis of the projected operating cash flows of the company is a secondary source of repayment in the event that the sale or refinancing does not occur and the bridge loan must be converted to term debt.

**Key Risks**

The major risks associated with bridge loan financing include:
• The asset is not sold at the price anticipated or by the expected deadline.
• The asset was not valued correctly at the time the loan was made, or has deteriorated in value due to mismanagement or changing market conditions.
• Prospective buyers of the asset disappear through changes in market conditions, inability to raise financing, or the appearance of unexpected contingencies such as legislative or environmental changes.
• The debt or equity markets have deteriorated due to changes in the economy.

These risks are mitigated by a careful analysis to ensure a strong cash flow of the company or project as a secondary source of repayment for the loan.

**Mortgage Financing**

**General Features**

Mortgage financing is generally a long-term loan that provides the lender with a lien on property as security for the repayment of the loan. The company has use of the property and the lien is removed when the obligation is fully paid. A mortgage generally involves real estate. For property such as machines, equipment, or tools, the lien is called a chattel mortgage. Lenders will generally allow a loan as a percentage of property market value of as much as 75-80%, depending on the property and market. In the event of default, this advance percentage allows the lender a margin of error on market value and selling expenses.
Loan Purpose
The purpose of mortgage financing is to provide funds for the acquisition or refinance of real property. Financial institutions may finance the acquisition, construction, or refinance of real property that is:

- Income producing; i.e., office buildings, shopping centers, hotels, etc.
- Owner-occupied property for use in the owner’s direct day-to-day business operations.

Collateral Considerations
The lender will take a security interest in the property being financed as well as an assignment of rents and leases. Other collateral may be taken as an abundance of caution.

Source of Repayment
In the case of property of a business or owner-occupied real estate, the primary source of repayment is the cash flow from the business. In addition, the value of the asset being financed may provide a second way out of the loan.

In the case of investment property, a careful analysis of the cash flow provided by the tenant leases will be key to repayment. The overall marketability of the asset through liquidation provides a second way out.

Key Risks
The key risks in mortgage financing are:

- The initial accuracy of the asset valuation and the continued maintenance of the value of the underlying asset.
- The strength and maintenance of the underlying cash flows of the asset.

The mitigants to these risks are to ensure, through careful monitoring, that the asset value and cash flow are maintained. In the event that the asset value falls below the required percentage of the loan value, the lender should request additional collateral or a reduction in the loan principal through prepayment.

Special Programs
In addition to direct lending through financial institutions, many banks participate in Jurisdictional programs that provide financing to companies. These programs are designed to get business and government to work together toward improving the economic development of the community. Several programs will be noted below, but you are encouraged to research information in your area for Provincial or Territorial-specific programs.

Industry Canada has a comprehensive program of services to help small business owners and potential entrepreneurs. Through the loan guarantee program, the Canada Small Business Financing Program provides short and long-term loans and leasing to eligible, credit-worthy start-up and existing small businesses that cannot obtain financing on reasonable terms through normal lending channels. Loan guarantees, not direct loans, are provided through participating financial institutions. Other programs provided through Industry Canada include:
Financial assistance, including loans to small businesses.
Access to capital, markets, information and skills development.
Business counseling and training.
Statistics and information by province and industry sector.
Assistance for exporters.
Assistance for minorities in business.

For more detailed information on any of these programs, contact your local SBA office or visit their website at www.strategis.gc.ca

Subordinated Debt

General Features
Subordinated debt is usually placed for a longer-term (7-12 years) than senior debt and interest is payable at a fixed rate. It is sometimes referred to as mezzanine debt if there are equity warrants or convertible features attached to the subordinated debt.

- An equity warrant entitles the holder at some specified or unspecified point in the future to buy a proportionate amount of common stock at a specified price and is issued with the debt.
- A convertible corporate security is exchangeable for a set number of another form of corporate security at a pre-stated price. For example, subordinated debt may be converted into common shares that generally provide a higher return.

Therefore, in addition to receiving the interest on the debt, the holder of subordinated debt may have rights to future equity ownership of the company. This brings the overall return higher than the stated interest rate on the debt.

The usual providers are insurance companies, pension and investment funds, or other long-term investors. Principal provisions in subordinated debt may include:

- In insolvency or bankruptcy, the senior lender (who has first priority claim on the company’s assets) will be paid out before the subordinated lender receives any payment.
- Payments of the subordinated debt (principal or interest) are prohibited if the senior debt is in default.
- No principal payments are scheduled on the subordinated debt until after final maturity on the senior debt.
- The senior lender will often seek the right to have all penalties, fees, and expenses of collection paid before the subordinated lender gets any payment.

Loan Purpose
The funds are used to finance the long-term needs of the company, including acquisitions, purchase of equipment or fixed assets, support permanent working capital, and refinance debt or equity, particularly in situations where a term longer than 5-7 years is needed or flexible amortization schedules may be required. Typically, 15% to 30% of acquisition financing is in the form of subordinated financing.
Collateral Considerations
Subordinated debt is usually unsecured or secured by junior liens (subordinate in bankruptcy claims) on the assets. In some cases, the lending institution may be granted stock options to own equity in the business as a sweetener to enhance the marketability of the debt and improve the overall return on the debt.

Sources of Repayment
The repayment structure of subordinated debt should be closely linked to the cash flows of the company. This layer of debt is appropriate in situations where cash flows will be generated over a longer period of time than traditional term debt allows. Recapitalizations or restructurings, significant capital expenditures, and acquisitions are examples of subordinated debt applications.

Key Risks
The key risks associated with subordinated debt financing are:

- Subordinated debt is considered “quasi equity” by the company’s creditors because it stands behind other debt in the event of liquidation.
- Subordinated debt is usually unsecured or at least has junior liens on the company’s assets.
- Pricing of subordinated debt is usually higher than for senior debt, which adds extra debt service burdens on the company’s cash flows.

These risks can best be mitigated by:

- Clearly understanding and accepting the risk and unsecured nature of issuing subordinated debt.
- Ensuring that the company exhibits sufficient operating cash flow to comfortably service all debt including the subordinated debt.
- Limiting the amount of senior debt and trade credit that the company can incur while the subordinated debt is in place.
- Establish a firm payout strategy for the subordinated debt that has a reasonable assurance of occurring.

If you are a senior lender to a company with subordinated debt in place, you should carefully read and understand the terms and conditions of the subordinated debt on your customer’s books. All subordinated debt is different and its terms and conditions should be compatible with the structure of your customer’s senior debt.

Since it stands behind other debt in liquidation, subordinated debt is generally considered to be “quasi-equity.” Other lenders may be willing to extend additional credit to the company as though the subordinated debt did not exist, as long as their debt is repaid first. Based on the long-term, generally unsecured nature of this debt, the risks can be greater than for senior debt. Pricing is higher than senior debt (usually 2% to 8% over senior debt), and covenants are generally required.
Private Placements

General Features

Another source of funds for companies is through a private placement. A private placement is the sale of debt or equity to a private or institutional investor, including individuals, insurance companies, pension funds, and investment companies. One of the major advantages of a Private Placement is that a prospectus does not need to be filed with the Provincial securities legislators. Private Placements are regulated by the Provincial securities agencies and the private placement must comply with the regulations in each Jurisdiction in which it is offered for sale. The Provincial agencies also stipulate rules for resale. The bank matches the company’s capital needs with institutional investors who provide the financing. The bank’s role is one of agent and arranger.

Financing that is arranged through private placements can include:

- Senior term loans.
- Subordinated debt.
- Debt with equity enhancements such as warrants.
- Common and preferred stock.

The structure of a debt private placement covers the full range of options:

- Secured or unsecured
- Fixed or floating rates
- Medium to long term
- Varying amortization schedules

Generally, the size of the transactions is $3 million or more for equity/mezzanine debt and $10 million or more for senior debt, with terms ranging from 3 to 15 years, with some extending to 30 years.

For the investor providing the funds, pricing for fixed-rate debt is generally 60 to 300 basis points over comparable Canada Treasuries. The type and number of financial covenants will vary according to the issuer’s or company’s credit quality and general market conditions.

Mezzanine issues (debt with equity enhancements) require coupons of 9% to 12% with an equity component yielding an all-in return of 13% to 23%; preferred and common stock securities, 25% to 35%.

The minimum amounts and required returns will vary with market conditions.
**Purpose**

Private placements are often referred to as “story paper.” The placement agent (investment banker) plays an important role in explaining the company’s strategy to investors. Recapitalizations or restructuring of the balance sheet, acquisitions, and significant capital expenditures are generally reasons why companies seek this form of financing. In addition, private placements may have one or more of the following benefits:

- Extended amortizations and maturities
- Fixed rate
- Covenant flexibility

**Collateral Considerations**

Collateral will be required depending on the risk of the company’s business strategy and the structure of the transaction. The benefit of a private placement is that the structure, covenants, and amortization schedules can be tailored to the company’s needs and profile and the asset booked by the investor is not subject to regulatory guidelines except as detailed under Provincial securities regulations.

**Sources of Repayment**

If the issue is in the form of debt, the repayment structure should be closely linked to the cash flows of the company. In addition, repayment may come from the following sources:

- Liquidation of assets
- Refinancing

**Key Risks**

The bank is not extending credit; therefore, the key risks revolve around the bank’s ability to effectively serve as financial advisor and placement agent.

**Loan Syndications**

**General Features**

A syndicated loan is a credit facility that is originated by one or more lead banks acting as agents and sold to a group of financial institutions as participants. Loan syndications may be done on either a “best efforts” or a fully underwritten basis. Syndicated loans spread the risk of large credit facilities across many institutions. The following structuring options are typical:

- Secured revolving lines of credit or term loans
- Floating rates
  Varying amortization schedules

Facilities can be structured as:

- Revolving or term senior
- Preferred stock
• Private equity
• Subordinated debt

A bank can participate in a syndicated loan either as a participant or an assignee.

• Participants agree to provide loans to the borrower, or purchase shares in the transaction, but do not have a contractual relationship with the borrower. If the transaction is a share issue, the shares are purchased from the agent bank (who maintains the contractual relationship with the customer) after the closing. The participant is not party to the credit agreement under the loan or share issue.

• Assignees agree to fund the loan or purchase shares in the transaction after the closing and do become party to the credit agreement. The assignment agreement creates a direct contractual relationship between the assignee and the borrower.

• Size of the transaction is generally $15 million or greater with terms of 364 days to 10 years.

**Loan Purpose**

Large financings requiring multiple banks generally occur in acquisitions, equity buyouts, recapitalizations or restructurings, and expansions or growth. A loan syndication is also employed where a corporation with multiple bank relationships wishes to coordinate its lenders with consistent pricing, documentation, covenants, and terms.

**Collateral Considerations**

Collateral requirements will be dependent on the underlying risk of the borrower and structure of the transaction.

**Sources of Repayment**

The repayment structure of the debt should be closely linked to the cash flows of the company.

**Key Risks**

The key risks associated with Loan Syndications are:

• In a best-efforts situation, your institution, as the agent bank, will provide only their best estimate of the interest rate, terms and conditions and the market’s appetite for the total amount of credit being syndicated.

• In a fully underwritten deal, your institution, as the agent bank, takes the risks of the entire principal amount of the debt offering and commits to the interest rate and the terms and conditions. Your institution will be required to hold the entire debt if you are unable sell off the debt offering.

These risks can best be mitigated by:

• Understanding the market place for credit to your customer’s industry.

• Checking with other financial institutions to get a feel for their interest in the deal before committing to your customer.
• Acquiring credibility in the marketplace for such transactions by gaining experience in marketing syndicated deals.

• Ensuring that your institution has the investment capacity and appetite to take the entire security if you are unable to sell off any portion of the issue.

High-Yield Debt

General Features

High-yield debt involves underwriting public debt issues for non-investment grade companies. Standard & Poor’s ratings of less than BBB are considered non-investment grade and have greater default risk than investment grade companies. High yield debt is often sold on a “best efforts” basis. Ratings of AAA, AA, A, and BBB are considered investment grade and have minimal risk of default.

The typical buyers of this debt are financial institutions, mutual funds, insurance companies, pension funds, and individual investors.

High-yield debt transactions are generally subordinated debt transactions but can include any of the following securities:

• Senior secured or unsecured term loans
• Subordinated debt
• Convertible securities (generally debt exchangeable for equity)

The key benefits of high-yield debt are:

• Fixed coupon rate
• 7-to-12 year term or longer
• Generally unsecured
• Varying amortization schedules
• Flexible covenants

Size of the transaction is generally $75 million or greater with terms of 7 to 12 years. Issues can be structured with call provisions (allows the issuer to repay the debt prior to maturity) after 3 to 6 years.

Purpose

High-yield debt is attractive to non-investment grade corporations involved in mergers and acquisitions, recapitalizations, refinancing, and project financings.

Collateral Considerations

The bank typically is not holding the debt but serving as a placement agent for the company. High-yield debt is generally unsecured although in recent times it is less uncommon to see the facility secured, although most likely in a subordinated position.
Source of Repayment
The repayment structure of the debt should be closely linked to the cash flows of the company.

Key Risks
Key risks associated with high yield debt are:
- Your institution, as the agent bank, provides your best estimate of the appetite of the market for such debt and the interest rate and terms and conditions that would be involved with such an offering.
- Changes in the market or adverse events within your customer could cause the debt placement of the issue to be unsuccessful
These risks can best be mitigated by:
- Understanding the market place for debt securities placed by businesses in your customer’s industry.
- Checking with other financial institutions to get a feel for their interest in the deal before committing to your customer.
- Acquiring credibility in the marketplace for such transactions by gaining experience in marketing syndicated deals.
- Ensuring that your institution has the investment capacity and appetite to take the entire security if you are unable to sell off any portion of the issue.

Commercial Paper

General Features
Commercial paper is a financing vehicle for companies with investment grade credit ratings (AAA to BBB) that need low-cost, short-term, unsecured financing. Maturities of commercial paper range from 2 to 270 days. Corporations issue commercial paper directly to investors who may have temporary idle cash to invest. Such instruments are unsecured and generally discounted (sold at less than face value and repaid at face value at maturity), although some are interest bearing. They can be issued directly by corporations or through brokers, and they are generally available for financings in amounts of $50 million or greater. The maturity of the note, credit rating of the issuer, market conditions, and investor demand determine the rate, which can float, or be interest fixed for the term of the paper.

Purpose
Commercial paper provides short-term working capital funding with flexible maturities and lower rates (than bank funding) for investment grade corporations.

Collateral Considerations
Commercial paper is an unsecured facility.

Sources of Repayment
Commercial paper issuers are top-rated companies. Bank lines of credit nearly always back commercial paper. This back-up line of credit covers maturing commercial paper notes in the
event that new notes cannot be marketed to replace them and the company still requires financing.

**Key Risks**

Commercial paper has the credit risk of the underlying issuer or corporation issuing the obligations. Issues are supported by a public debt rating and public disclosure of financial information. Rating agencies like Moody’s and Standard & Poor’s assign ratings to commercial paper and generally require the issuer to have committed back-up lines of credit with a financial institution.

**SPECIALIZED PRODUCTS**

The purpose of this section is to provide an overview and understanding of the application of each of the following products:

- Letters of Credit
- Bankers Acceptance
- Asset Securitization

In addition to defining the elements of each product, you will also

- Match structure with purpose.
- Identify sources of repayment.
- Determine the level of collateral required.
- Highlight and mitigate associated risks

**Letters of Credit**

**General Features**

A letter of credit (L/C) is an instrument issued by a bank on behalf of its customer that gives someone (beneficiary) the right to draw funds upon the presentation of papers or documents in accordance with its stipulated terms and conditions. While this definition applies to all L/Cs, a distinction is made between documentary or commercial L/Cs that are used to finance shipments of goods and standby L/Cs used for other purposes.

Documentary L/Cs are typically used in international trade where the customer is not well known or the customer’s credit is suspect. Typically, the L/C is issued by the importer’s bank, called the issuing bank. The issuing bank’s L/C signifies that the bank agrees to pay the importer’s obligation to an exporter resulting from a sales agreement, contingent upon receiving appropriate documentation with respect to the shipment. In return for the L/C, the importer agrees to pay the bank the face amount and any fees. The L/C essentially substitutes the issuing bank’s credit for that of the importer.

Standby L/Cs are issued in lieu of a guarantee and protect the beneficiary financially in the event the bank’s customer defaults. Standby L/Cs are used in commercial transactions and to guarantee performance on construction contracts. Banks provide this guarantee only for
the obligations of their most creditworthy customers in which there is little likelihood of nonperformance.

For example, a construction company contracts with a school district (beneficiary) to renovate the local high school. The school district requires a letter of credit from the contractor’s bank that gives the district the right to ask for payment from the bank of an agreed-upon amount should the contractor fail to perform in accordance with a written construction contract. The contractor will be required to pay a fee to the bank, generally a percentage of the amount of the letter of credit, for this facility.

**Documentary Letter of Credit (L/C)**

- **Step 1:** Importer’s bank in Japan issues L/C to U.S. exporter’s bank in the U.S.
- **Step 2:** U.S. exporter ships goods to Japanese importer and presents shipping documents to U.S. Bank. The U.S. bank credits the U.S exporter’s account for the face amount of the L/C and debits the Japanese Bank’s account.
- **Step 3:** The U.S. Bank sends the documents to the Japanese Bank, which in turn debits the Japanese importer’s account for the amount of the sale and presents the shipping documents to the importer.
- **Step 4:** The Japanese importer claims the goods with the shipping documents.

**Purpose**

Commercial or documentary L/Cs are commonly used in international trade. Standby L/Cs are used in business practice for firms to bid on projects or to purchase materials. With some awarded contracts, it may be a requirement that the company performing the work submit a performance guarantee via a standby L/C until the contract is satisfactorily completed.

**Collateral Considerations**

Requiring collateral is dependent on the analysis of the customer’s ability to repay should the L/C be drawn.
**Sources of Repayment**

Your financial institution must be prepared to pay the beneficiary of the letter of credit, if the request for such payment conforms to the letter of credit's terms and conditions. The letter of credit instrument serves as an indemnity covering the contract between the parties. With standby letters of credit, generally the parties satisfactorily fulfill their mutual obligations, without the need to draw under the standby letter of credit.

**Key Risks**

Key risks associated with letters of credit are:

- Your institution bears the payment risk on behalf of your customer.
- Your customer may be unable to perform under the contract associated with the letter of credit.
- Your customer may be unable to pay your financial institution if the letter of credit is presented for payment.

These risks can best be mitigated by:

- Reserving borrowing capacity under your customer’s credit facility to cover the full amount of the letter of credit if it is presented for payment.
- Making a thorough assessment concerning your customer’s ability to perform and complete the work as detailed in the contract.
- See Documentary Letters of Credit for detailed information about the documentation requirements for this product.
- For further information, please refer to the Industry Resources section.

**Banker’s Acceptance**

**General Features**

A Banker’s Acceptance (B/A) is a time draft (signed, written order by which one party instructs another party to pay a specified sum to a third party on a certain date) drawn on and accepted by a bank. In banker’s terms it is a draft issued by a borrowing company that has been backstopped, or “accepted” by a Bank. The acceptance means that the bank guarantees payment should the issuing company be unable to do so. A BA is utilized for different purposes in Canada and the U.S.

In Canada, a B/A is a negotiable instrument traded in the money market and can only be issued by a Bank (as defined in the Bank Act). It is often an alternate form of committed financing for large mid-market and corporate Canadian companies, which they utilize in place of bank lines. B/A’s can also be an investment vehicle.

In the U.S. a B/A can only be issued for funding a specific purpose. It is the customary means of effecting payment for merchandise sold in import-export transactions and a source of financing used in international trade. The draft allows a specified period of time after the goods are delivered and the draft is presented before payment is due. When the importer’s bank accepts the draft, the bank guarantees that it will pay the draft on maturity. Essentially, the bank replaces the importer's credit with its own credit. The exporter may attempt to sell
the banker’s acceptance to an investor at a discount that is consistent with the market rate. Alternatively, the bank may extend credit by buying the acceptance from the exporter at a discount. The bank sells it in the banker’s acceptance market and at maturity pays off the investor at face value as the payment from the importer comes due. BA’s in the U.S. are traded on the secondary markets.

**Purpose**

In Canada, B/A’s are a common source of financing primarily for large, investment rated companies, and an investment vehicle for others who purchase the B/A in the money market and earn the coupon rate. B/A’s are issued at a discount equivalent to the interest rate, and settled at full value on maturity.

In the U.S., Banker’s Acceptances are primarily used to finance international trade.

**Collateral Considerations**

Collateral is generally unnecessary due to the underlying creditworthiness of the bank that supports these facilities. However, the banks that “accept” the B/A on behalf of a borrower would need to ensure that borrower has the ability to honor its commitment when due and may require collateral on the B/A facility.

**Source of Repayment**

The draft is paid under the terms of the instrument, usually 30 to 180 days, and is structured to match the flow of goods and services that are being financed by the underlying transaction.

**Key Risks**

The credit risk of a B/A is minimized since it has the unconditional guarantee of the accepting bank. Secondarily, it is a liability of the importer of the transaction for the full-face amount. They are traded in a highly active secondary market.

**Asset Securitization**

**General Features**

Asset securitization involves pooling homogeneous groups of assets, such as credit card receivables, mortgages, corporate accounts receivable, auto, or consumer loans and financing them with securities (credit instrument that signifies ownership) that are sold to investors. These securitized notes or bonds are serviced by the cash flow of the underlying pool of assets.

In structuring an asset-backed security, the assets are generally sold to a specially created trust or special-purpose corporation that issues the securities that are collateralized by the assets. Credit enhancements in the form of guarantees, over-collateralization, or a reserve account are generally required. This credit enhancement provides the opportunity for higher ratings by rating agencies.

A financial institution may assume one or more of the following functions in an asset securitization transaction:
• Set up or facilitate the set-up of a trust or special-purpose corporation to purchase assets and issue securities.
• Act as a servicing agent to structure the transaction, analyze the assets, perform due diligence and credit reviews, and monitor the credit quality of the portfolio.
• Collect interest and principal payments on the assets and transmit those funds to investors.
• Be the supplier of the assets that are securitized.
• Provide some form of credit support or credit enhancement.
• Provide liquidity support to the trust.

Asset securitization involves three steps as illustrated below:

• **Step 1**: Isolate assets with a predictable cash flow.
• **Step 2**: Package the assets.
• **Step 3**: Sell the securities in the market.
Purpose

The primary reasons for the rapid growth in asset securitizations are as follows:

• Off-balance sheet financing: Originators of loans or companies with accounts receivable can improve their return on capital and lower their cost of funds by selling and securitizing on-balance sheet assets, thus reducing on-balance sheet leverage and freeing up capital for further origination and servicing.

• High quality assets: Many investors with quality and/or maturity restrictions find AAA-rated asset-backed securities a highly attractive alternative to government, agency, and single-A and BBB-rated corporate bonds.

• Success of the asset-backed market to date: highly rated asset-backed securities have performed consistently with their ratings, increasing investor confidence and broadening the market.

Collateral Considerations

Investors should analyze the underlying quality of the assets collateralizing the securities. Rating agencies can also provide this credit determination. As stated earlier, credit enhancements are an important part of asset-backed structures. The key factors to consider will vary depending upon the type of collateral (auto loans, credit cards, etc.) and forms of credit enhancements (guarantees, collateral values, etc.).

Sources of Repayment

For most asset-backed securities, the more important consideration is how variable the cash flows are. The major factors influencing the timing of cash flows are as follows:

• Early amortization of principal caused by defaults, refinancings, and prepayments of principal

• Default by the servicer

Key Risks

There are two sources of risk with asset-backed securities:

• Risk of loss of principal due to defaults of loans or accounts receivable in the collateral pool

• Risk of the timing of interest and principal payment will differ with expectations, altering the anticipated return on investment

In addition to the agency rating, the investor needs to analyze the pool of assets and the forms of credit enhancement in order to make an independent determination of risk of loss.
WHEN DOES FORM OF ORGANIZATION SUGGEST A GUARANTEE IS NEEDED?

The borrower’s form of organization influences whether a guarantee may be needed. The following paragraphs briefly describe typical considerations for whether the borrower’s form of organization suggests the need for a guarantee. Generally, for privately held borrowers a guarantee is highly desirable whenever the form of organization does not already incorporate personal liability (i.e. the borrower is not a proprietorship or a general partnership). In addition, guarantees are highly recommended when there are multiple legal entities sharing the same ownership, and when it is possible for the borrower’s financial resources to be easily redistributed within those entities.

**Corporation**

The loan policies of most lenders require that a corporation’s major stockholders guarantee a loan to a closely held corporation. The shareholders, directors, officers and employees are not otherwise liable for corporate debt. Sometimes, a corporation may be asked to guarantee the debt of another entity. For example, a holding company may be asked to guarantee the debt of a subsidiary or vice versa.

**Limited Liability Company**

The loan policies of most lenders also require that a limited liability company’s members guarantee a loan to the limited liability company. Otherwise, the members have no individual liability for the debts of the company.

**Limited Partnership and General Partnership**

General partners may be required to guarantee a partnership debt, even though the general partners are legally liable for partnership debt. The guarantee agreement allows you to act sooner. Without the guarantee, you may have to exhaust all efforts against the partnership before you could take action against the individual partners depending on the Jurisdiction. Limited partners are not liable for the debt of the partnership unless they have provided guarantees.

**Limited Liability Partnership**

Most banks’ loan policies require that partners in the limited liability partnership guarantee a loan to the partnership. Otherwise, the partners have no individual liability for partnership debts incurred by the partnership after registration as a limited liability partnership.

**Spouse**

Spouses of the original borrower and guarantors are often required to execute guarantees. Almost every Jurisdiction in Canada has some form of a property system to determine the interest of a husband and wife in property acquired during marriage. However, each Jurisdiction is different and you should refer to the Matrimonial Property Act of the Jurisdiction, or its equivalent, or consult with your legal counsel to determine how the ownership of assets is determined.
In addition, each Jurisdiction may have other laws or rules governing the provision of guarantees and supporting security and you should check with legal counsel. As an example, in Alberta, there are two pieces of significant legislation:

- **Dower Act**, which stipulates what is required with respect to spousal consent regarding transactions concerning the matrimonial homestead. This includes what is required in order to take security on the matrimonial homestead and realize on the asset should it become necessary.

- **The Guarantees Acknowledgement Act**, which details what is required to ensure a Guarantee is valid and enforceable.

And in Saskatchewan the Farm Security Act governs the relationship between lenders and owners of farmland, and sets out procedures that must be followed before farm land can be foreclosed on.

**Collection from a Guarantor in Event of Default**

Most Jurisdictions provide guarantors with legal defenses and claims against the lender that can make collection difficult. Your position is strengthened if you obtain evidence that the guarantor understands the terms of the loan and you should consult legal counsel to determine what the regulations are in your Jurisdiction. As an example, the Alberta Guarantees Acknowledgement Act ensures that a notary public certifies that the guarantor has reviewed the guarantee and understands the contents. Such advice can limit the defense available should you need to realize on the guarantee.

If there is any change in the terms and conditions of the loan, which could increase the risk to the guarantor, the written statement of understanding and consent by the guarantor, as well as a written confirmation that the guarantee is not affected by the change should be obtained. You should also notify the guarantor of any defaults that occur in the underlying credit transaction, although this is not required by law in all Jurisdictions.

Guarantees are usually subject to the statute of limitations, particularly with respect to the length of time after default and demand that they remain valid. However, renewals of the guarantee are not normally required in view of the language contained in the guarantee. If in doubt, ask your legal counsel.

A guarantee, by its terms, can be revoked at any time but only as to debt incurred after the revocation, but the limitations are determined based on the wording in the guarantee. As a general principle, once the guarantor notifies the lender in writing that it no longer will guarantee the loan of the borrower, the lender makes a “determination” of the amount of the loan that is guaranteed. The standard form of Guarantee may provide a notice period between the provision of the written termination by the guarantor and the determination date. The guarantor remains liable for the determined amount of debt. The determined amount of debt is generally the amount outstanding at the time the notification is received or the determination date if there is a notice period plus any future amounts that the lender is contractually obligated to advance if such obligation was made prior to the revocation. Any amounts repaid and then redrawn after the determination would not be secured. Of particular note, in the case of a demand, revolving credit, any amounts advanced after the
notification was received and determination made are considered to be new loans and would not be subject to the guarantee.

If for some reason you are requested to release a guarantee and are prepared to do so, you must first get written confirmation and consent from any and all of the other guarantors or the release may make the remaining guarantors not liable for the debt.
Requirements

The guarantee agreement must be signed on or prior to the date of the note so that there is no question of consideration to the guarantor. Consideration may consist either of actual value (money or other things of value) given to the guarantor or your reliance on the guarantee in making your credit decision.

If not signed in your presence or that of another official of your institution who knows the identity of the signer, you should require a signature guaranty from a financial institution acceptable to you. The signature guarantee indicates that an authorized officer or employee of the institution guaranteeing the signature has witnessed the signing and verified the identity of the signer. If the signature later proves to have been unauthorized or fraudulent, the guaranteeing institution will be liable for any damages you suffer. In certain Jurisdictions, such as Alberta under the Guarantees Acknowledgement Act, the guarantee must be witnessed by a notary public, which negates the requirement for a signature guarantee from another financial institution.

Special Consideration for Enforcing Canada Small Business Financing Loan Guarantees

If you have obtained a guarantee under the Canadian Small Business Financing Loan program, your ability to collect on that guarantee could depend on the following:

- Did you close the loan in accordance with the authorization letter, as appropriately amended and document the transaction as required under the program?
- Did you comply with the monitoring and credit management requirements of the authorization?
- Did you act with normal prudence for the industry and comply with the rules and regulations of the program in managing the liquidation?

Comfort Letters

Comfort letters are letters issued to lenders by companies to indicate support for another entity borrowing from the lender. They are sometimes offered and accepted in lieu of guaranties. They are most often issued by parent companies in connection with subsidiary borrowings. They generally fall short of an absolute promise to pay the borrowing entity’s debt. Companies that favor comfort letters are generally public companies that do not want to have to include contingent liabilities in their financials.

Comfort letters are generally legally enforceable. They are an adequate substitute for guaranties only if they contain a solid commitment of the issuer to step up to repayment obligations incurred by its subsidiary. You should attempt to find out how the issuer has performed under similar previous arrangements.

For articles that discuss credit issues related to guarantees, see the Loan Guarantees Credit and Lending Studies Pack by RMA. For help in understanding how to document guarantees, see the Loan Documentation section of this Dimension.
**Loan Covenants**

Loan covenants are a part of the formal loan agreement and outline certain acts that are to be performed (affirmative covenants) and others that must be refrained from (negative covenants). They are designed to protect the bank’s interest. They are also an essential complement to monitoring the relationship and provide early warning signs of a troubled credit.

Covenants accomplish the following:

- Covenants are designed to protect the bank. A covenant is to be drawn sufficiently tight to protect the bank while at the same time providing flexibility to the company to allow the business to be run effectively.

- Covenants should identify key risk points in the company’s operating profile. In establishing these guidelines, it is very important to identify the specific risks against which the bank needs to be protected and to prevent certain actions by the company that could jeopardize the timely repayment of the loan.

- Covenants should be those that the bank expects to enforce. As a bank, the discipline of using only those covenants that you intend to enforce is important. Including covenants that are not enforced gives rise to confusion, negotiating lapses, and inconsistencies—particularly when the bank tries to enforce other covenants in the loan agreement.

- Covenants provide timely warning signs. Covenants provide the bank with a mechanism that raises warning flags in the event of deterioration in a company’s financial performance, as well as guidelines within which a company’s operating and financial performance must comply.

- Covenants bring the borrower back to the table. More important, covenants provide the bank with the means of bringing the borrower back to the negotiating table to restructure the loan in the event established guidelines are breached.

- Covenants do not repay loans. In determining appropriate covenants, always remember that covenants, no matter how well crafted, do not repay the bank’s loan.

In crafting a covenant package, it is important to determine your key objectives to ensure effective monitoring and management of the exposure and to assure the bank of the optimal chance of repayment.

The following paragraphs explain covenant objectives and provide examples of specific covenants that can achieve those objectives. Covenant objectives we will discuss are:

- Full Disclosure of Information
- Protection of Net Worth
- Protection of Cash Flow
- Protection of Asset Quality
- Control Growth
- Maintenance of Key Management
• Assurance of Legitimacy and the Company as a Going Concern
• Profitability for the Bank

See the *Dimension 6* discussion of loan documentation for additional terms and conditions generally included with covenants in loan agreements.

**Full Disclosure of Information**

To make competent, ongoing lending decisions, the bank must have an in-depth understanding of the company. This understanding only comes with full and timely disclosure. Full disclosure also helps maintain regular contact with the company and close control over the lending relationship.
The following are some covenants that provide full disclosure of information:

<table>
<thead>
<tr>
<th><strong>AFFIRMATIVE COVENANTS</strong></th>
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</thead>
<tbody>
<tr>
<td><strong>Timely Delivery of Financial Information</strong></td>
<td>Delivery of financial statements is defined (if audited, within 120 days of fiscal year end; if unaudited, within up to 120 days of year end, or if delivered on a more frequent basis, 5, 10, 20, or up to 30 days after the end of the accounting period in question). While not always a requirement, it is often appropriate to have an officer’s certification attesting to the accuracy of the information and indicate compliance/non-compliance with all covenants.</td>
</tr>
<tr>
<td><strong>Timely Delivery of Business Plans</strong></td>
<td>Include a minimum of 3 years’ projections</td>
</tr>
<tr>
<td><strong>Timely Delivery of an Auditor’s Management Letter</strong></td>
<td>Delivery of an Auditor’s letter stating that the company complies with all of its loan agreements and indicating whether or not any event of default has occurred under any of the company’s loan agreements is specified.</td>
</tr>
<tr>
<td><strong>Consistent Preparation of Financial Statements</strong></td>
<td>The Auditor’s letter should also state that there has been no change in the basis on which financial statements have been prepared and, in addition, that such financial statements have been prepared using accounting procedures that remain consistent with previous financial statements and in accordance with GAAP.</td>
</tr>
<tr>
<td><strong>Location of the Company’s Books and Records</strong></td>
<td>The company’s books and records will be maintained in a specific location and will be available for inspection by the bank.</td>
</tr>
<tr>
<td><strong>Maintenance of Rights of Inspection</strong></td>
<td>Representatives of the bank shall be permitted to inspect any or all records and property to verify the actual confirmed ownership of the property and other assets, the authenticity of the furnished statements evidencing ownership of such assets (that should also include, where appropriate, either a landlord’s waiver or a mortgagee’s waiver), as well as the actual condition of the assets.</td>
</tr>
<tr>
<td><strong>Timely Delivery of Information on Contingent Liabilities</strong></td>
<td>Delivery of any information of actual or probable litigation, guarantees provided by the company, or changes in contracts or the status quo that might affect the company’s business is indicated.</td>
</tr>
<tr>
<td><strong>Maintenance of Operating Accounts with the Bank</strong></td>
<td>All principal operating accounts are to be maintained with the bank.</td>
</tr>
</tbody>
</table>
Protection of Net Worth

Notwithstanding the significant importance of cash flow, much of a company’s basic financial strength, intrinsic debt capacity, and its ability to absorb downturns lie in the amount and quality of its net worth. Net worth covenants always should be targeted at assuring the continued strength and growth of net worth.

The following are examples of covenants that protect net worth:

<table>
<thead>
<tr>
<th>AFFIRMATIVE COVENANTS</th>
<th>Details</th>
</tr>
</thead>
</table>
| **Maintenance of Minimum Tangible Net Worth** | The maintenance of a minimum tangible net worth will ensure an adequate cushion for the senior debt provider, particularly when combined with carefully crafted maximum leverage ratios.  
*Note:* Such covenants should include the formula for the calculation of minimum tangible net worth, and, most important, this formula or basis for calculation always should be communicated and explained to the customer.  
With a seasonal loan, this covenant can still be reinforced, provided the bank has retained the right to receive regular and timely financial statements. |
<p>| <strong>Other Financial Ratios</strong> | With seasonal and other permanent working capital loans, banks can monitor the maintenance of such ratios as sales to net worth, net profit to net worth, and debt to depreciated capital assets. |
| <strong>Maintenance of Keyperson Life Insurance</strong> | If the continued success of the company depends on one or two key individuals, keyperson life insurance, equal to the amount of the bank’s exposure, should be maintained with the benefits assigned to the bank. |
| <strong>Current Settlement of Tax Liabilities and Other Accrued Expense Obligations</strong> | Tax payments should be made as they fall due, insurance premiums should be kept up to date, and restrictions on the cash payment of accrued officers’ salaries may also be appropriate. |
| <strong>Timely Delivery of Information on Contingent Liabilities</strong> | Delivery of any information of actual or probable litigation, guarantees provided by the company or changes in existing contracts that might affect the business should be specified. |</p>
<table>
<thead>
<tr>
<th>NEGATIVE COVENANTS</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Restrictions on Change of Ownership and Management</td>
<td>No change permitted in the management or ownership of the company. May not be applicable to a public company</td>
</tr>
<tr>
<td>Restrictions on Repurchase of Stock/Payment of Dividends</td>
<td>Restrictions placed on dividend payments, the repurchase of stock, or “disguised” reductions of equity such as higher officers/shareholders’ salaries, loans to officers/shareholders, or loans to affiliates and/or subsidiaries, inflated rental expenses paid to affiliates, or transfer pricing considerations as between affiliates.</td>
</tr>
<tr>
<td>Restrictions on Mergers or Other Changes in the Business</td>
<td>Activities that may indirectly negatively impact the equity capital base including restrictions on mergers and acquisitions or a material change of business are restricted.</td>
</tr>
<tr>
<td>Restrictions on Additional Borrowings</td>
<td>Even if the existing bank is secured, it is important that additional borrowings from other sources are curbed to preserve cash flows for servicing the existing bank’s debt. This restriction should also extend to other forms of financing such as leases, affiliated company loans, or shareholder loans unless they are on terms that strengthen the existing bank’s loan.</td>
</tr>
<tr>
<td>Financial Ratios</td>
<td>Restrictions on leverage can be imposed as maximum leverage = total liabilities to tangible net worth; or maximum leverage = funded bank debt to tangible net worth.</td>
</tr>
<tr>
<td>Restrictions on Sales of Assets</td>
<td>While more important in permanent working capital and term loans, fixed assets, in particular plant and machinery, may be a very important way out for the unsecured bank or for the bank secured only by current assets, should the latter be insufficient to liquidate the loan. As a result, restrictions on sales of assets are important, even in the case of a seasonal loan. Finally, since in nearly all cases these fixed assets are essential for generating the future cash flows of the company, removal of the source of these cash flows should be prevented.</td>
</tr>
<tr>
<td>Negative Pledge</td>
<td>Restriction on pledging of assets for security on other financings. Can be either a total restriction or a threshold level. In cases where existing debt is unsecured, the covenant may contemplate provision of security to the existing lender on a pari passu basis if security is provided to any other lender.</td>
</tr>
</tbody>
</table>
Protection of Cash Flow

Under most commercial bank credit policies, cash flow is regarded as the primary source of repayment. The bank should have every opportunity to monitor the level of cash flow as well as to preserve its quality.

Following are examples of specific covenants that protect cash flow:

<table>
<thead>
<tr>
<th>AFFIRMATIVE COVENANTS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintenance of Minimum Levels of Cash Flow</td>
<td>This objective can be achieved by using financial covenants that address minimum interest coverage, minimum fixed charge coverage (all debt service and lease payments), and minimum cash flow to current maturities.</td>
</tr>
<tr>
<td>Derivation of these covenants will comprise variations including:</td>
<td></td>
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<tr>
<td>• EBIT/Interest</td>
<td></td>
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<tr>
<td>• EBITDA/Interest</td>
<td></td>
</tr>
<tr>
<td>• (EBITDA +/- Extraordinary gains or losses) /Interest</td>
<td></td>
</tr>
<tr>
<td>• (EBITDA-Capital Expenditures)/Interest</td>
<td></td>
</tr>
<tr>
<td>• (EBITDA-Capital Expenditures-Change in Adjusted Working Capital)/Interest+CPLTD</td>
<td></td>
</tr>
<tr>
<td>• Net Income + Depreciation/CPLTD</td>
<td></td>
</tr>
<tr>
<td>• (Net Income + Depreciation + Interest +/- Extraordinary gains or losses)/(Interest + CPLTD)</td>
<td></td>
</tr>
<tr>
<td>• Funded debt/EBITDA</td>
<td></td>
</tr>
</tbody>
</table>

Note: EBITDA = Earnings before Interest, Taxes, Depreciation, and Amortization of non-cash charges; CPLTD = Current Portion of Long-term Debt (refer Dictionary).
### Maintenance of Working Capital and Liquidity

This affirmative financial covenant requires the maintenance of a minimum level of working capital. Greater control may be exercised with this covenant by excluding certain elements of working capital (for example, prepaid expenses) or allowing only a certain percentage of inventory to be included (for example, 50%), regardless of whether or not the loan is secured.

- **Current Ratio:** Working capital can also be linked to a minimum current ratio. This ratio, combined with the insistence on timely delivery of financial statements, particularly during the “season,” ensures that the bank has the ability to move quickly in the event of a material decline in asset values.

- **Quick Ratio:** Use of a quick ratio can be an extremely powerful tool, particularly as a warning sign against the artificial improvement in liquidity created by, for instance, a buildup in slow moving inventory.

**Note:** Such ratios may be very useful if applied over a full financial year or on a rolling four-quarter basis. However, recognize that during the buildup of inventory and receivables, the company may be experiencing a negative cash flow and negative interest coverage, until the contraction of the current assets being financed has occurred.

As a result, a more effective tool may be to link working capital to sales as a means of ensuring efficiency in the management of working capital. A typical covenant, therefore, would be for working capital not to exceed a certain percentage of sales.

### Maintenance of Property and Casualty Insurance

Whether or not the bank is secured, the maintenance of insurance should be equal to the market value of the assets based on a current valuation from an acceptable valuation expert.
### NEGATIVE COVENANTS

| Restrictions on Capital Expenditures and Leases | Limitations on investments in capital expenditures and lease expenditures will be limited to levels that ensure sufficient cash for servicing and repayment of bank debt. |
| Restrictions on Investments | Limitations on investments such as other companies or assets not used in the business. These are generally not permitted without the bank’s written consent. |
| Other covenants include restrictions on: |  |
|  | • Repurchase of stock/dividends |
|  | • Officers’ salaries |
|  | • Borrowings |
|  | • Sales of assets |
|  | • Mergers/change in business |

#### Protection of Asset Quality

This objective achieves the following:

- Protects the underlying cash flow generating power of the company—the primary source of repayment
- Preserves the bank’s secondary source of repayment - the liquidation value of the assets
The following are examples of covenants that protect asset quality:

### AFFIRMATIVE COVENANTS

<table>
<thead>
<tr>
<th>Maintenance of Property, Plant, and Equipment in Good Repair</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not only should a level of good repair be maintained, but the bank should also retain rights of access to inspect the property, plant, and equipment at the bank’s convenience.</td>
</tr>
</tbody>
</table>

Also included are the following covenants:

- Maintenance of property and casualty insurance
- Maintenance of keyperson life insurance
- Current settlement of tax liabilities and other accrued expenses
- Maintenance of minimum levels of working capital and liquidity ratios
- Maintenance of rights of inspection
- Maintenance of information on contingent liabilities
- Maintenance of intellectual property rights, including trademarks, patents, formulas and licenses.

### NEGATIVE COVENANTS

<table>
<thead>
<tr>
<th>Restrictions on:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Sales of assets</td>
</tr>
<tr>
<td>• Capital expenditures</td>
</tr>
<tr>
<td>• Leases</td>
</tr>
<tr>
<td>• Investments</td>
</tr>
<tr>
<td>• Loans to officers</td>
</tr>
<tr>
<td>• Mergers or a change in the company’s business</td>
</tr>
</tbody>
</table>
Control Growth

This objective achieves the following:

- When companies grow, major drains on cash flow are caused by the investment in both working capital as well as fixed assets and increased dividend payments.
- With private companies, uncontrolled growth can be potentially damaging, and therefore an ability to monitor and, to some extent, control the rate of growth is important.

The following are examples of specific covenants that control growth:

<table>
<thead>
<tr>
<th>AFFIRMATIVE COVENANTS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintenance of maximum debt/equity</td>
<td>The maintenance of a maximum debt to equity ratio will allow the company to increase debt provided the equity increases proportionately.</td>
</tr>
<tr>
<td>Maintenance of minimum tangible net worth</td>
<td>The maintenance of minimum tangible net worth is essential and will ensure an adequate cushion for the senior debt provided.</td>
</tr>
</tbody>
</table>

Permanent working capital loans arise as a result of both successful and unsuccessful, planned and unplanned growth patterns within companies. To interfere with the evolution of a company’s growth profile can, in certain circumstances, create liability problems for the bank (see the Lender Liability discussion in Dimension 7).

There are, however, a number of ways in which growth can be controlled without interfering with the day-to-day management of the company. These include ratios such as maximum debt/equity and restrictions on line availability, both in terms of absolute dollar amounts as well as through the judicious and conservative use of a formula-driven borrowing base.

<table>
<thead>
<tr>
<th>NEGATIVE COVENANTS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Restrictions on:</td>
<td>• Working capital/sales</td>
</tr>
<tr>
<td></td>
<td>• Borrowings and growth in leverage</td>
</tr>
<tr>
<td></td>
<td>• Capital expenditures</td>
</tr>
<tr>
<td></td>
<td>• Leases</td>
</tr>
<tr>
<td></td>
<td>• Investments</td>
</tr>
<tr>
<td></td>
<td>• Mergers or a change in the business</td>
</tr>
</tbody>
</table>
**Maintenance of Key Management**

This objective achieves the following:

- Maintenance of a company’s management team. Our initial risk assessment included the character of management and any change may have a direct impact on the ability of the company to repay debt.
- Continued quality of corporate management.

Below are examples of specific covenants that maintain key management:

<table>
<thead>
<tr>
<th><strong>AFFIRMATIVE COVENANTS</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintenance of Employment Contracts</td>
<td>Examples of covenants that would specifically meet this objective include maintenance of contracts with key employees in a form acceptable to the bank. Other examples include key-person life insurance.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>NEGATIVE COVENANTS</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Restrictions on:</td>
<td>• Mergers or a change of business</td>
</tr>
<tr>
<td></td>
<td>• Change in management</td>
</tr>
<tr>
<td></td>
<td>• Officers’ salaries</td>
</tr>
</tbody>
</table>
Assurance of Legitimacy and the Company as a Going Concern

Covenants should be established to ensure that the company remains a viable entity—legally and economically—to effectively service and repay its debt.

Below are specific examples of covenants that assure legitimacy:

<table>
<thead>
<tr>
<th>AFFIRMATIVE COVENANTS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Maintenance of Corporate Existence</strong></td>
</tr>
<tr>
<td>• Preservation of the corporate entity including corporate licenses and other necessary legal filings</td>
</tr>
<tr>
<td>• Maintenance of key-person life insurance</td>
</tr>
<tr>
<td>• Maintenance of information on contingent liabilities</td>
</tr>
<tr>
<td>• Maintenance of pension funds</td>
</tr>
<tr>
<td>• Maintenance of appropriate levels of insurance</td>
</tr>
<tr>
<td>• Information regarding lawsuits</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>NEGATIVE COVENANTS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Restrictions on:</strong></td>
</tr>
<tr>
<td>• Asset sales</td>
</tr>
<tr>
<td>• Mergers/acquisitions or a change in the business</td>
</tr>
<tr>
<td>• Change in management or ownership</td>
</tr>
</tbody>
</table>
Profitability for the Bank

Covenants should be devised to maintain profitability for the bank—whether it is prepayment conditions in the event of fixed rate loans or penalty default interest in the event of problem loans.

Below are specific examples of covenants that achieve profitability for the bank:

**AFFIRMATIVE COVENANTS**

<table>
<thead>
<tr>
<th>Require:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Maintenance of banking services, in particular chequing accounts</td>
</tr>
<tr>
<td>• Default pricing in loan agreements. However, the wording must be such that payment of default pricing in no way waives the requirement to remedy the default or limits the rights of the bank.</td>
</tr>
<tr>
<td>• “Step up” or “step down” pricing related to declines or improvements operating performance. The operating performance metric should never show a pricing that relates to a default situation. For example, if a covenant requires that Debt/Equity be maintained at less than 3:1, the step up pricing should never go above 3:1.</td>
</tr>
</tbody>
</table>
**Documenting the Credit**

There are two important steps in documenting the credit: Understanding the type of borrowing entity, and elements of loan documentation. In this section of Dimension 6 we will provide a general discussion of each topic. It is always important to understand the legal requirements to accurately document loans in your Jurisdiction, and to consult your legal counsel for specific transaction documentation at your bank.

**Borrowing Entities, Authority and Execution**

To put together an enforceable loan documentation package, you must understand the type of entity. This is true for borrowers, guarantors and third party security interest grantors. Equally important, you must know who is authorized to sign the loan documents. In this section we will provide an overview of these borrowing entities:

- Sole Proprietor
- General Partnership
- Limited Liability Partnership
- Limited Partnership
- Joint Venture
- Corporation
- Limited Liability Company or Corporation
- Business Trust/Income Trust
- Nonprofit Corporation
- Trust
- Estate and Guardianship

**Sole Proprietor**

A sole proprietor is an individual operating as a business. There is no separate business entity, only the individual operating the business. The sole proprietor is personally liable for all debts of the business. You can look to the owner’s personal assets to satisfy claims. The sole proprietorship’s life is finite; if the owner dies or becomes incapacitated, the business ends. A sole proprietor can do business under another name (e.g., Joseph Nusser operates as Jiffy Market).

**Identification Needed**

Each financial institution will have guidelines with respect to acceptable indentification. However, for new clients it is generally preferable to obtain two pieces of ID, with one being a picture ID such as a current driver's license with photograph.
Authorization

Generally, an individual may commit to borrow money after reaching the age of majority (18 or 19 in most Jurisdictions) if they have not been declared mentally incompetent. A person's age can be verified by a driver's license. Mental competency is usually assumed unless there are appearances to the contrary.

When another person is signing on behalf of your customer, obtain a power of attorney from the customer. The power of attorney should be enduring and specific. An enduring power of attorney is one that continues to be effective even if the grantor becomes mentally incompetent after granting the power. A specific power of attorney is limited in coverage to the transaction contemplated. Have the power of attorney reviewed by your legal counsel.

Signatory Requirements

• An individual "doing business as" (d/b/a) another name should sign his or her correct legal name with the d/b/a noted only if required elsewhere in the loan documents—not in or above the signature line. The d/b/a should be noted in the loan documents only if requested by the customer. This should never give rise to an inference that the d/b/a is the borrowing entity.

• Example of Signature: _____________________________
  John R. Brown

• Example of d/b/a in text: John R. Brown, d/b/a Valley Variety Store

Special Considerations

Almost every Jurisdiction in Canada has some form of a property system to determine the interest of a husband and wife in property acquired during marriage. However, each Jurisdiction is different and you should refer to the Matrimonial Property Act, or its equivalent, of the Jurisdiction or consult with your legal counsel to identify what restrictions apply to executing judgments against and pledging of matrimonial assets. Obtain signatures on guaranties and collateral documents as dictated by the laws in your Jurisdiction. Consult with your legal counsel.

• A married woman should sign using her own name.
  ➢ Example: "Jane T. Brown" not "Mrs. John Brown."

Comments

• Consider obtaining a legal opinion on the adequacy of the documents delivered to you. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.

General Partnership

A general partnership is a business operated by two or more general partners. Partnership assets, liabilities, and ownership are accounted for separately and distinctly from the personal assets and liabilities of individuals. However, the individual partners are liable for the partnership debts, and their personal assets are exposed to liability for the debts. Each general partner is by law an agent of the partnership.
Identification Needed

Partnership agreement. General partnerships do not always have written partnership agreements. Obtain the agreement from the partnership. If there is no formal written agreement, obtain a written statement that none exists.

Partnership certificate. If required by the Jurisdiction in which the partnership is doing business, you can obtain a copy from your customer or from the appropriate agency.

Authorization

You need to obtain a partnership resolution to borrow, guarantee or grant collateral interests, whichever is applicable. It is necessary to do this even if the Partnership Agreement states who can borrow, give guarantees, or grant collateral interests in assets on behalf of the partnership as the Partnership Agreement may change.

Signatory Requirement

- The legal names of all designated partners or one or more of the general partners as designated in the partnership agreement are required. Each signature appears after the word "By" and above the typed or printed name followed by a comma and the words: "Partner" or "General Partner."

Example: XYZ Partnership

By ________________________________

John R. Brown, General Partner

By ________________________________

Mary P. Smith, General Partner

- Almost every Jurisdiction in Canada has some form of a property system to determine the interest of a husband and wife in property acquired during marriage. However, each Jurisdiction is different and you should refer to the Matrimonial Property Act (or its equivalent) of the Jurisdiction or consult with your legal counsel to identify what restrictions apply to executing judgments against and pledging of matrimonial assets. Obtain signatures on guaranties and collateral documents as dictated by the laws in your Jurisdiction. Consult with your legal counsel.

- A married woman should sign using her own name.

  Example: "Jane T. Brown" not "Mrs. John Brown."

Comments

Consider obtaining a legal opinion on the adequacy of the documents delivered to you. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.
Limited Liability Partnership

A limited liability partnership is a general partnership that has qualified as a limited liability partnership by complying with applicable registration laws of the Jurisdiction. Not all Jurisdictions have approved limited liability partnerships. The partners in a limited liability partnership are not liable for the debts of the partnership unless the debts existed prior to the election to become a limited liability partnership or they have guaranteed the debts. This means they would be liable for any unpaid term debt or revolving credit debt that existed at the time the registration was completed. They would not be liable for any new debt that was not paid, including a renewal of an existing revolving line of credit. They are permitted to participate in management of the partnership business.

Identification Needed

• Partnership agreement. General partnerships do not always have written partnership agreements. Obtain the agreement from the partnership. If there is no formal written agreement, obtain a written statement that none exists.

• Partnership certificate. If required by the Jurisdiction in which the partnership is doing business, you can obtain a copy from your customer or from the appropriate agency.

• Proof of registration for Limited Liability Partnership status. Obtain the certificate from your customer or from the appropriate agency.

Authorization

You need to obtain a partnership resolution to borrow, guarantee or grant collateral interests, whichever is applicable. It is necessary to do this even if the agreement states who can borrow, give guarantees, or grant collateral interests in assets on behalf of the partnership as the agreement among the partners can change.

Signatory Requirement

• The legal names of all designated partners or one or more of the general partners as designated in the partnership agreement are required. Each signature appears after the word "By" and above the typed or printed name followed by a comma and the words: "Partner" or "General Partner".

Example: XYZ, L.L.P. (or Limited Liability Partnership)

By______________________________

John R. Brown, General Partner

By______________________________

Mary P. Smith, General Partner

Almost every Jurisdiction in Canada has some form of a property system to determine the interest of a husband and wife in property acquired during marriage. However, each Jurisdiction is different and you should refer to the Matrimonial Property Act (or its equivalent) of the Jurisdiction or consult with your legal counsel to identify what
restrictions apply to executing judgments against and pledging of matrimonial assets. Obtain signatures on guarantees and collateral documents as dictated by the laws in your Jurisdiction. Consult with your legal counsel.

- A married woman should sign using her own name.
  - Example: "Jane T. Brown" not "Mrs. John Brown."

Comments

- Consider obtaining a legal opinion on the adequacy of the documents delivered to you. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.

Limited Partnership

A limited partnership is made up of one or more general partners and one or more limited partners and is governed by the Partnership Act of the relevant Jurisdiction. The purpose of a limited partnership is to allow one or more individuals to provide capital without having to assume liability for debts. Limited partners are not liable for the debts of the partnership unless they have guaranteed the debts. They can only lose the amount of their investment in the partnership. They are not agents of the partnership and take no part in control or management of the business. General partners control the activities of the business and have full liability.

Identification Needed

Limited partnership agreement. A limited partnership must have a written agreement. Obtain the agreement from the partnership.

A Limited Partnership certificate. Obtain the certificate from your customer or from the appropriate agency in your Jurisdiction.
**Authorization**

You need to obtain a partnership resolution to borrow, guarantee or grant collateral interests, whichever is applicable. It is necessary to do this even if the agreement states who can borrow, give guarantees, or grant collateral interests in assets on behalf of the partnership as the agreement among the partners may change.

**Signatory Requirement**

- The legal named of all designated partners or one or more of the general partners as designated in the partnership agreement are required. Each signature appears after the word "By" and above the typed or printed name followed by a comma and the words: "General Partner" for a limited partnership.

Example: XYZ, L.P. (or Limited Partnership)

By __________________________

John R. Brown, General Partner

By __________________________

Mary P. Smith, General Partner

- Almost every Jurisdiction in Canada has some form of a property system to determine the interest of a husband and wife in property acquired during marriage. However, each Jurisdiction is different and you should refer to the Matrimonial Property Act (or its equivalent) of the Jurisdiction or consult with your legal counsel to identify what restrictions apply to executing judgments against and pledging of matrimonial assets. Obtain signatures on guarantees and collateral documents as dictated by the laws in your Jurisdiction. Consult with your legal counsel.

- A married woman should sign using her own name.
  - Example: "Jane T. Brown" not "Mrs. John Brown."

**Comments**

- Consider obtaining a legal opinion on the adequacy of the documents delivered to you. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.
Joint Venture

A joint venture is a one-time partnership for a specific purpose. It may be among individuals, partnerships, corporations, trusts or limited liability companies. While the participants in a joint venture are most likely liable for the debts of the joint venture, it may be necessary to obtain guarantee to ensure they are. .

Identification Needed

Joint venture agreement. A joint venture does not legally require a written agreement. However, if one exists you should obtain the agreement from the joint venture.

Authorization

Joint venture borrowing resolution to borrow, guarantee or grant collateral interests, whichever is applicable. It is necessary to do this even if the agreement states who can borrow, give guarantees, or grant collateral interests in assets on behalf of the joint venture as the agreement between the joint venturers can change. For each joint venturer that is an entity and not an individual, you must also obtain proof that the persons signing for each entity are authorized to do so. You should obtain authorization appropriate to the type of joint venturer entity involved.

Signatory Requirement

- The legal name of each joint venturer signing the document is required. The name should be preceded by the word “By” and should be above the signature line or lines for persons signing on behalf of the joint venturer. The legal names of all designated signers for the participants in the joint venture are required. Each signature appears after the word "By" and above the typed or printed name followed by a comma and the title of the person signing.

Example:

XYZ, a Joint Venture

By: Brown and Smith, L.P., a joint venturer

By: ______________________________
John R. Brown, General Partner

By: ______________________________
Mary P. Smith, General Partner

By: B & S., Inc., a joint venturer

By: ______________________________
Mary P. Smith, President
Almost every Jurisdiction in Canada has some form of a property system to determine the interest of a husband and wife in property acquired during marriage. However, each Jurisdiction is different and you should refer to the Matrimonial Property Act (or its equivalent) of the Jurisdiction or consult with your legal counsel to identify what restrictions apply to executing judgments against and pledging of matrimonial assets. Obtain signatures on guarantees and collateral documents as dictated by the laws in your Jurisdiction. Consult with your legal counsel.

A married woman should sign using her own name.

- Example: "Jane T. Brown" not "Mrs. John Brown."

**Comments**

- Consider obtaining a legal opinion on the adequacy of the documents delivered to you. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.

**Corporation**

A corporation is an artificial entity created by law. It consists of:

- Shareholders who own the corporation, elect directors, and vote on major corporate acts.
- Board of directors who manage the corporation and elect officers. The Business Corporation Act of the Jurisdiction sets the minimum number of directors a corporation must have. In many cases, only one is required.
- Officers who operate the corporation on a day-to-day basis. They are removable at the will of the board of directors. The corporation’s bylaws should be reviewed to determine the number of officers, their titles, and limitations on their powers.

A corporation exists independently and apart from the people who own it. Its shareholders are liable only to the extent of any unpaid purchase price for their investment in the corporation. The corporation is responsible for its own debts. The shareholders, officers and directors are not personally liable for unpaid debts of the corporation unless they have guaranteed the debts.

**Identification Needed**

- **Articles of Incorporation.** In order to establish a corporation, its organizers must file articles of incorporation with an appropriate Jurisdictional agency. The articles prove the existence of the corporation. They include the name of the corporation, how long it will exist, its business purpose, the names of its organizers and original directors and other information required by the law of the Jurisdiction in which it is organized. You should obtain a filed copy either from the customer or from the appropriate agency.

- **Bylaws and any amendments.** Each corporation also establishes bylaws. The corporation’s bylaws provide the rules under which the company will function. The bylaws establish the number of directors; number, title and duties of officers; frequency and timing of directors’ meetings; and other matters necessary to the operations of the business. You should examine the bylaws to determine whether they place any
restrictions on actions of the directors. In smaller corporations, shareholders sometimes reserve powers, such as the obtaining of major financing or encumbering of significant corporate assets, to themselves. You should obtain a copy from the customer.

- **Certificate of Status.** A certificate of status is issued by the appropriate agency if the corporation is in current compliance with all reporting and fee requirements set by the Jurisdiction. Obtain periodically to ensure compliance. At a minimum, obtain a certificate each time a new or renewed loan is documented or every two years.

**Authorization**

- You must obtain a copy of the Board of Directors’ Resolution certified by the Corporate Secretary. This is the document evidencing the action by which the directors of the corporation granted authority to officers to make agreements and sign documents on behalf of the corporation. The resolution indicates who can borrow, give guarantees, or grant collateral interests in corporate assets on behalf of the corporation.

- It is common practice to obtain an Incumbency Certificate signed by the Corporate Secretary when there is a change in officers after a resolution has been delivered to you.

- If the Secretary is authorized to borrow on his or her signature alone, considered prudent to have the certificate also signed by an officer other than the Secretary (unless your Jurisdiction permits one-person corporations and this is one such corporation).

**Signatory Requirement**

- The corporate name, as it appears on the Articles of Incorporation or the Certificate of Status, may be typed above the signature line. Each signature appears after the word “By” and above the typed or printed name of the individual authorized to sign for the borrower followed by a comma and the individual's corporate title.

  Example: ABC, Incorporated

  By: ______________________________
  John R. Brown, Treasurer

- If the corporate name is at the top of the document, it may be omitted from the signature block.

- Example: ABC Incorporated is named at the top of the document.

  By: ______________________________
  John R. Brown, Treasurer

**Comments**

- Consider obtaining a legal opinion on the adequacy of the documents delivered to you. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.

- Almost every Jurisdiction in Canada has some form of a property system to determine the interest of a husband and wife in property acquired during marriage. However, each Jurisdiction is different and you should refer to the Matrimonial Property Act (or its equivalent) of the Jurisdiction or consult with your legal counsel to identify what
restrictions apply to executing judgments against and pledging of matrimonial assets. Obtain signatures on guarantees and collateral documents as dictated by the laws in your Jurisdiction. Consult with your legal counsel.

- A corporation may authorize its officers or agents to appoint certain individuals to sign cheques, drafts, or other orders for payment, transfer, or withdrawal of funds or other property on deposit with your institution. You should obtain the corporate resolution authorizing such appointments.

**Business Trusts/Income Trusts**

A business trust or income trust is a combination of a corporation and a partnership. The trust is defined by the relationship created by the beneficiaries (usually the unitholders) and the trustee, which is normally a corporate trustee. The trust is operated much the same as a corporation but is not taxable. The taxes flow through to the unitholders.

**Comments**

- Unlike most forms of organization, a business trust is not considered a legal entity and as such has some legal issues that require the expertise of legal counsel. When doing business with a trust, it is prudent to obtain a legal opinion on the adequacy of the documents delivered to you both with respect to authorizations and security issues. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.
Nonprofit Corporation

A nonprofit corporation is a public or quasi-public entity established for administration of public affairs or for charitable, religious, or benevolent purposes. It usually has a Board of Directors who manage the corporation and elect officers and a staff, answerable to the board, who run the day-to-day operations of the association. The corporation is responsible for its debts. The directors, officers and staff are not liable for unpaid debts of the corporation unless they have guaranteed the debts. Your Jurisdiction may have different statutory requirements for charitable, religious, and benevolent corporate entities. Review the laws in your Jurisdiction to determine which of the following provisions apply.

Identification Needed

- **Charter of Association.** In order to establish a nonprofit corporation, its organizers must file a charter of association with an appropriate agency. The articles include the name of the corporation, how long it will exist, its business purpose, the names of its organizers and original directors and other such information required by the law of the Jurisdiction in which it is organized. You should obtain a filed copy either from the customer or from the appropriate agency.

- **Bylaws and any amendments.** Each corporation also establishes bylaws. The corporation's bylaws provide the rules under which the company will function. The bylaws establish the number of directors, number, title and duties of officers, frequency and timing of directors’ meetings, and other matters necessary to the operations of the business. You should obtain a copy from the customer.

- **Certificate of Status.** A certificate of status is issued by the appropriate agency if the nonprofit corporation is in current compliance with all reporting and fee requirements set by the Jurisdiction. Obtain periodically to ensure compliance. At a minimum, obtain a certificate each time a new or renewed loan is documented or every two years.

Authorization

- **You must obtain a Board of Directors’ Resolution certified the Corporate Secretary.** This is the document evidencing the action by which the directors of the corporation granted authority to officers to make agreements and sign documents on behalf of the corporation. The resolution indicates who can borrow, give guarantees, or grant collateral interests in corporate assets on behalf of the corporation.

- **Obtain an Incumbency Certificate signed by the corporation Secretary when there is a change in officers after a resolution has been delivered to you.**

- **If the Secretary is authorized to borrow on his or her signature alone, it is considered prudent to have the certificate also signed by an officer other than the Secretary (unless your Jurisdiction permits one-person nonprofit corporations and this is one such corporation).**
**Signatory Requirement**

- The association name, as it appears on the Articles of Incorporation or the Certificate of Status, should be typed above the signature line. Each signature appears after the word “By” and above the typed or printed name of the individual authorized to sign for the borrower followed by a comma and the individual’s title.

- Example: Friendship Association

  By: ______________________
  Sara Gray, Secretary

**Comments**

- Consider obtaining a legal opinion on the adequacy of the documents delivered to you. Identify any legal issues, as opposed to business issues, and use legal counsel to resolve them. You should not attempt to resolve legal issues on your own even if you have a law degree. Your primary focus is customer service.

- You may also enter into transactions with Unincorporated Associations and/or Nonprofit Associations. You must obtain a copy of such association’s organizational papers to determine who is authorized to grant signature authority. Signatory requirements are the same as for Nonprofit Corporations.

**Trust**

A trust is an entity that has an obligation of special trust to another entity. A business or common-law trust is a formal business organization whereby personal and/or real property is held and managed for the benefit of persons who are holders of transferable certificates issued by the trustees. Trusts are also set up by individuals as estate planning devices for the benefit of other individuals and charities. The trustee is not liable for the unpaid debts of the trust unless the trustee has guaranteed the debts.

**Identification Needed**

- You need to obtain a certified copy of the Trust Agreement. Obtain the copy from the customer.

- You should also personally know the trustee’s identity or verify the trustee’s identity by other means as required by your financial institution.

**Authorization**

Same as for identification

**Signatory Requirement**

- The legal names of all designated trustees or one or more of the trustees as designated in the trust agreement are required. Each signature appears after the word “By” and above the typed or printed name followed by a comma and the words: “Trustee under Trust Agreement (date of trust agreement) for the benefit of (Name of beneficiary)”

Example:
By: _____________________________
David Hart, Trustee under Trust Agreement dated 6/10/99 for the benefit of the Workers Union

Comments

- Obtain a legal opinion on the authority of the trustee to borrow funds for the trust and to grant a security interest in the trust's assets.
Estate and Guardianship

Estates and guardianships have an obligation of special trust to other persons. They come into existence when a person dies or is subject to guardianship proceedings leading to appointment of a guardian for the person. The person appointed as administrator/executor/personal representation/guardian is not personally liable for unpaid debts of the estate or guardianship unless he or she has guaranteed the debts.

Identification Needed

- You need to obtain a certified copy of court order appointing administrator/executor/personal representative/guardian. Obtain from the court with which the estate or guardianship is established.
- You should also personally know the identity of the administrator, executor, personal representative, or guardian or verify the identity from another source as required by your financial institution.

Authorization

Certified copy of court order appointing administrator/executor/personal representative/guardian. The court order will indicate the extent of the person’s authority.

Signatory Requirement

The legal name of estate or guardianship as designated in the court order is required. The signature appears after the word "By" and above the typed or printed name followed by a comma and the words identifying the individual's relationship to the borrowing entity.

Example: By: ______________________________
John R. Brown, Executor for the Estate of Mary Brown

Example: By: ______________________________
John R. Brown, Guardian for Mary A. Brown

Comments

If not clearly stated in the court order, obtain a legal opinion on the authority of the administrator/executor/personal representative/guardian to borrow funds and grant a security interest in the assets of the estate or guardianship.
ENTITIES CHART

The following chart summarizes the characteristics of the entities we have discussed.

<table>
<thead>
<tr>
<th>Entity</th>
<th>Organizational Structure</th>
<th>Legal Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietor</td>
<td>A one-person business entity. No formal organization required. Some Jurisdictions require a trade name filing.</td>
<td>The sole proprietor is always personally liable for all debts incurred by the sole proprietorship.</td>
</tr>
<tr>
<td>General Partnership</td>
<td>A business entity in which two or more persons are engaged. May have, but is not required to have, a written partnership agreement. Some Jurisdictions require a trade name filing.</td>
<td>Each general partner is personally liable for unpaid debts of the partnership. Provision of guarantee by the General Partner(s) may negate the requirement to realize on partnership assets before pursuing the General Partner as is required in some Jurisdictions.</td>
</tr>
<tr>
<td>Limited Liability Partnership</td>
<td>A general partnership that has registered with the appropriate Jurisdiction become a limited liability partnership. Some Jurisdictions require a trade name filing.</td>
<td>General partners are not liable for any new debt of the partnership.</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>A business entity involving two or more persons, at least one as a general partner, and at least one as a limited partner. A written partnership agreement is usually required as well as a filing with the appropriate Jurisdictional office. The general partner or general partners manage the business.</td>
<td>Each general partner is personally liable for unpaid debts of the partnership. (Refer General Partnership). The limited partners are not personally liable for such debts.</td>
</tr>
<tr>
<td>Joint Venture</td>
<td>Two or more business entities joined by contract for a joint business venture. The existence and organizational setup of each participant in the joint venture must be determined.</td>
<td>The separate entities involved in the joint venture are not generally individually liable for debts of the joint venture.</td>
</tr>
<tr>
<td>Corporation</td>
<td>An artificial entity created by statute. It has directors, officers and shareholders. Each Jurisdiction requires that Articles of Incorporation be filed to establish the entity. By-laws of the corporation describe the relationship among directors, officers and shareholders.</td>
<td>Directors, officers and shareholders are not personally liable for debts of the corporation.</td>
</tr>
<tr>
<td>Organizational Structure</td>
<td>Legal Liability</td>
<td></td>
</tr>
<tr>
<td>--------------------------</td>
<td>-----------------</td>
<td></td>
</tr>
<tr>
<td><strong>Business Trust or Income Trust</strong></td>
<td>If the trustee is a corporate trustee it has directors, officers and shareholders. Each Jurisdiction requires that Articles of Incorporation be filed to establish the entity. By-laws of the corporation describe the relationship among directors, officers and shareholders.</td>
<td>Directors, officers and shareholders (commonly called unitholders) are not personally liable for debts of the trust.</td>
</tr>
<tr>
<td><strong>Nonprofit Corporation</strong></td>
<td>An artificial entity created by statute. Each Jurisdiction requires that organizational documents be filed to establish the entity.</td>
<td>Directors, officers and managers are not liable for debts of the nonprofit corporation.</td>
</tr>
<tr>
<td><strong>Trust</strong></td>
<td>An entity created by executing a trust agreement. The trust agreement names a trustee or trustees and discloses the powers granted to the trustee or trustees.</td>
<td>The trustee is not personally liable for debts of the trust.</td>
</tr>
<tr>
<td><strong>Estate or Guardianship</strong></td>
<td>An entity created by order of a court that has jurisdiction to do so within the Jurisdiction where created. The powers of the personal representative are limited to those provided in the court order.</td>
<td>The personal representative, executor, administrator is not personally liable for debts of the estate or the person for whom the guardianship is established.</td>
</tr>
</tbody>
</table>

**FUNDAMENTAL LEGAL DOCUMENTATION**

Documentation errors are a major cause for lender loss on commercial loans. If needed documents are not obtained and accurately completed, collection of a loan may be legally impossible. In this section, we will discuss the requirements of these legal documents:

- Proposal Letter/Term Sheet
- Commitment Letter
- Promissory Notes
- Loan Agreements
- Security Agreement, Deeds of Trust, Mortgages
- Lines of Credit: Committed and Uncommitted
- Participation Agreements
Proposal Letter/Term Sheet

In order to get negotiations started you may provide a potential borrower with a written
proposal letter or term sheet.

You should include the following in the proposal letter or term sheet:

- A clear listing of all information you will require the potential borrower to deliver to you
  before further considering a possible loan transaction.
- A summary of the significant terms you would require in any extension of credit to the
  potential borrower, such as reporting requirements, collateral requirements, guarantee
  requirements, etc. A significant term is any term that would influence the potential
  borrower to accept or reject any credit offer you make.
- A statement that the terms included are not the only terms that you may require. For
  example: “Terms other than those in this proposal letter/term sheet may be agreed to
  between the Lender and the Borrower.”
- A statement that you will require additional documentation to close the loan. For
  example: “If an extension of credit is approved, additional documentation will be required
  and may include, but not be limited to, a loan agreement, guarantee, and collateral
  documents.”
- A clear statement that you are not making a commitment to lend. For example: “This
  proposal is not a commitment to lend, but is an outline of the principal terms on which the
  Lender may be willing to lend. Any final commitment of the Lender to lend, if any is
  made, will be contingent upon all approvals required by the Lender, including, but not
  limited to, credit approval and signing of loan documents satisfactory to the Lender.”
- An expiration date for the proposal. For example: “Contact us by July 4, 2004, or we will
  assume that you have no interest in pursuing the financing discussed in this proposal.”

Commitment Letter

You may follow up your proposal letter or term sheet with a commitment letter, provided the
credit has been approved within your financial institution. Your proposal letter or term sheet
outlined the general terms of a possible transaction with the customer. Your commitment
letter will go much further. It will obligate you to go forward with the transaction. It should
serve as the basis for the credit relationship between you and your customer. You should
include the following in the commitment letter:

- A clear listing of all information you will require the potential borrower to deliver to you
  before the loan closing.
- A summary of the significant terms you will require. A significant term is any term that
  would influence the potential borrower to accept or reject the credit offer you make.
- A statement that the terms included are not the only terms that you may require. For
  example: “Terms not included in this letter will also apply, including those set out in any
  other documents signed in connection with the loan or loans made by the Lender.”
• A statement that you will require additional documentation to close the loan. For example: "At closing, additional documentation will be required as described in this commitment letter."

• A clear statement that the commitment is a non-assignable offer made solely to borrower.

• An expiration date for the commitment. For example: "This commitment must be accepted by delivery to the Lender, on or before 5:00 P.M., local time on July 5, 2XXX, of a signed copy of this letter accepted by Borrower together with the Commitment Fee. Time is of the essence of this offer. If acceptance and payment of the Commitment Fee are not made by the date and time stated above, this commitment shall automatically expire without further notice."

**Comments**

• Lender commitment letters include a statement of required fees, the payment schedule, collateral requirements, financial covenants and any conditions precedent to the transaction, including required appraisals. Most commitments also require that the borrower execute loan documents in a form acceptable to the financial institution or its legal counsel.

• Do not send commitment letters in situations where you do not intend to be committed to lend.

• Include as many of the material terms of the loan documentation as possible in the commitment letter.

• If the commitment letter is not a standard letter approved by your financial institution or was not drafted by legal counsel, have it reviewed by legal counsel before sending.

• Some lenders use commitment letters as the basic loan agreement with their borrowers. In such cases, the commitment letter includes an acceptance block where the borrower signs to show agreement with the terms in the letter. When that is done, the commitment letter becomes the loan agreement.
Promissory Notes

A promissory note is a written promise by one person to pay money to another. The person making the promise is called the maker of the note. The person to whom payment is made is called the payee. In some cases, the commitment letter or loan agreement will have an Evidence of Indebtedness clause, which negates the requirement to have a promissory note signed.

Content

The promissory note must contain language that will avoid interpretations that could lead to legal action. If your institution uses preprinted forms, you should not modify them in any respect other than selecting optional provisions. If a borrower insists on changes, you should consult legal counsel.

The entity to which a negotiable promissory note is transferred becomes a holder in due course if certain conditions are met. First, the note must be negotiable. The potential holder in course must receive the note in exchange for value given, usually money, by that person to the payee (the original party entitled to payment on the note). The maker (the original obligor on the note) might have a legal defence against the payee that would legally permit the maker to withhold payment. If the holder in due course is unaware of that defence at the time of transfer, the maker cannot use that defence to withhold payment from the holder in due course. In order for a promissory note to be negotiable, it must:

- Be signed by the maker (the original obligor on the note).
- Contain an unconditional promise to pay a fixed amount of money.
- Be payable to the order of an individual or entity or to the bearer (holder) of the note.
- Be payable at a set time or on demand.

In addition, your promissory note must specify:

- The interest rate.
- An acceleration clause that gives you the right to declare the remaining balance due either "on demand" or payable upon an event of default regardless of the original payment schedule.

Types of Loans

(The Repayment Terms in the Promissory Note Must Match the Loan Type)

- **Demand**: A demand loan is payable by the borrower whenever you make demand for payment. A promissory note may be made payable upon "the earlier of demand or" a specified date or by a specified installment schedule.

- **Time loan**: In a time loan transaction, the payee extends credit to the maker for a period of time until the payment is due. It may be payable in a single payment or in installment payments. Once any part of the loan is repaid, the amount cannot be re-borrowed. If the time is longer than one year, the loan is a term loan.

- **Revolving credit**: In a revolving credit transaction, the borrower is permitted to borrow all or part of the principal amount, repay it all at once or in part, and re-borrow it up to the
committed amount. The note may have a demand feature making it payable in full on demand or at a specific date.

- **Non-revolving multiple advance loan**: In a non-revolving multiple advance loan transaction, the borrower is permitted to borrow all or part of the principal amount. Amounts borrowed and repaid cannot be borrowed again.

### Loan Agreements

A loan agreement is a written contract that describes the lending arrangement. It specifies your rights and duties and those of the borrower. It states the conditions under which the loan was granted and criteria the borrower must continue to meet.

Some lenders use commitment letters as the basic loan agreement with their borrowers. In such cases, the commitment letter includes an acceptance block where the borrower signs to show agreement with the terms in the letter. When that is done, the commitment letter becomes the loan agreement.

**Purpose**

You may wish to establish certain conditions for making the loan, set restrictions to safeguard sources of repayment, or limit the future activities of the borrower. You cannot enforce any terms unless they are in writing and the borrower has agreed to them. The conditions, covenants and restrictions of a loan agreement can give you an early warning of deterioration in the financial condition of the borrower.

**Type of Loan Agreements**

A letter agreement that has been accepted and agreed to by the borrower is sufficient for most revolving credit lines with a term of less than one year. Where a longer term is involved or the transaction is complex or the risk high, a formal credit agreement is more effective. Term loans and multi-year commitments generally involve added risk because of the reliance on the borrower's ability to maintain earning power over time. The loan agreement helps you monitor the creditworthiness and debt service capacity of the borrower during the life of the loan.

**Content of Loan Agreements**

Your legal counsel should draft loan agreements so that they are tailored to the particular loans. They should include the following:

**Terms and conditions:**
- Description of the loan by type, size, date, repayment, and security
- Roles of parties to the transaction, such as, lender, borrower, guarantors, etc.

**Representations and Warranties**

The borrower makes representations and warranties to affirm the facts and data you are relying upon. For example, the borrower represents itself as a certain legal entity, legally organized and able to enter into the loan transaction. It is often advisable to require an attorney’s opinion letter to ensure that the borrower correctly understands the
representations and warranties and that these are indeed true. An opinion letter is provided by the borrower’s counsel and expresses an opinion that the loan documents have been duly executed and that they constitute the legal, valid and binding obligation of the company. Requiring an opinion letter is a means of double checking the representations. A borrower may believe they are true and accurate, but on a technicality there may be an error in the document that only an opinion letter will discover and disclose.

Affirmative and negative covenants (see Loan Covenants elsewhere in Dimension 6) that spell out promises by the borrower to:

- Provide full disclosure of information
- Protect net worth
- Protect cash flow
- Protect asset quality
- Control growth
- Maintain key management
- Assure legitimacy and the company as a going concern
- Maintain profitability for the lender

**Conditions of Lending**

Conditions of lending describe events that must occur before loans will be made.

- Delivery of required financial statements.
- Delivery of certificates of good standing, borrowing resolutions, guaranties, etc

**Events of Default**

Events of default specify events that entitle you to remedies, such as:

- Breach of covenants.
- Insolvency.
- Failure to pay.
- Misrepresentations.
- Liens/seizure of property by creditors.
- Material adverse change. A material adverse change would be a change in the customer’s condition, financial or otherwise, that you would consider adverse to the customer and potentially damaging to the customer’s ability to carry out the terms of the loan transaction. You must consult with your lawyer before using this type of default to call a loan, as it may create lender liability risks.
Remedies

Remedies specify what the lender can do (in addition to its normal rights as a creditor under laws applicable in the appropriate Jurisdiction) when default occurs, such as:

- Call the loan or loans.
- Grant waivers (temporary or permanent).
- Renegotiate the deal.
- Foreclose on collateral or require additional collateral.

Doing nothing is not an option. If a default occurs, your inaction could be considered a waiver. The waiver could be used to establish a course of dealing, or a precedent, between you and your customer and challenge the entire agreement.

Miscellaneous

- Notices: When required, to whom and mailing addresses of the parties
- Who pays expenses
- Governing law: The Jurisdictional law that will be used to settle disputes
- Procedure for waivers and consents

Security Agreement

A security agreement is an agreement that creates or provides for a security interest in assets of the borrower or some third party to secure repayment of a loan(s). It is an agreement between two parties, the grantor of the security interest (the Debtor) and the lender (the Secured Party). It is taken when you are not willing to make a loan based solely on the cash flow prospects of your customer. You want collateral to serve as a secondary source of repayment. A security interest cannot attach unless there is an agreement.

Note also that a security agreement attaches your collateral only. To have legally enforceable access to your collateral, you must also perfect your security interest through additional means, such as filing a Financing Statement under the PPSA.

Requirements in the Personal Property Security Act (PPSA)

(Also see Lien Perfection elsewhere in Dimension 6)

- **Written.** Unless you are in possession of the collateral, the security agreement must be in writing. When you are in possession of the collateral, the security agreement does not have to be in writing. Nonetheless, it is a good policy to always require a written security agreement.
- **Signature.** The debtor's signature must appear on the security agreement. The signature does not have to be acknowledged or witnessed.
- **Description of the Collateral.** The PPSA requires that the description reasonably identify the collateral. You should clearly identify exactly what collateral you are taking. This can help to avoid collateral disputes with the borrower or other lenders. This can be accomplished by the inclusion of a broad statement with attached lists covering specific collateral. The PPSA provides that you may describe collateral on a financing statement.
with broad terms such as “all present and after acquired property” but the rule remains that the security agreement must reasonably identify the collateral.

- In certain instances the security agreement must describe real estate. A description of land may be required when the security agreement covers crops, growing or to be grown, minerals or timber to be cut. Proceeds do not have to be specifically described.

- Each Jurisdiction of the PPSA has somewhat different requirements and you should ensure you understand the requirements in your Jurisdiction.

**Other Provisions You May Require**

- **Description of the Obligation.** The security agreement should describe the indebtedness and obligations secured by the collateral.

- **Warranties and Representations.** Among other things, such as representations as to the corporation's standing and financial condition, the security agreement should contain a statement that the debtor owns the collateral free of all security interests and liens.

- **Covenants of a Debtor.** The debtor should agree to refrain from selling the collateral, should pay taxes on it, insure it, and otherwise keep it in good condition.

- **Remedies in the Event of Default.** The security agreement should spell out what you may do in the event of default.

- **Documentation Requirements.** Security agreements are usually tailored to the particular collateral.

**Mortgages**

Real estate is not covered under the PPSA. In order to perfect a security interest in real property you need to obtain a mortgage or a debenture. While the PPSA does allow a floating charge on land, it is simply for notification purposes to other lenders and does not constitute a perfected security interest.

**Mortgages**

- A mortgage is an agreement between two parties, a mortgagor and a mortgagee. The mortgagor is the party granting the lender an interest in real property to secure repayment of a loan. The mortgagee is your institution. If the borrower does not repay the loan, you can foreclose on the mortgage to obtain partial or full payment of the loan.

**Debenture**

- A security instrument that can either be fixed charge or floating charge, or a combination of both. A floating charge debenture is similar in concept to a General Security Agreement under the PPSA in that it provides a floating charge on all of the assets of the company. A fixed charge is similar to a mortgage in that it provides a fixed charge on specifically identified assets of the company including real estate.

**Lines of Credit: Committed and Uncommitted**

There are three types of lines of credit: unadvised credit lines, demand credit lines and committed credit lines.
**Unadvised Lines of Credit/Guidance Lines**

You may obtain approval for a loan amount greater than the amount requested by a borrower because you anticipate that a customer will have a future financial need and you want to be able to quickly approve the additional amount. Some lenders call the additional amount an unadvised line of credit. Others call it a guidance line. No "commitment" or "terms and conditions" letter is sent to the customer. You must not make any oral or written communication of the approval to the customer.

**Demand Lines of Credit**

A demand line of credit is established for a specified period of time and expresses your intention to extend credit as required by the borrower but are subject to demand, or a request for repayment at the discretion of the lending institution. The written agreement must make it clear the loans are “payable on demand” and you should make no contradictory oral or written representations. The loan will be evidenced by a demand promissory note. These are referred to as demand loans, and while the intent is that they be payable on demand, legal precedence requires that a minimum notice period be provided to the borrower. You should not commence any demand proceedings without consulting with the appropriate department in your financial institution (i.e. the credit department or impaired loans group).

Requirements for Documenting the Terms of a Demand Line of Credit are:

- Date and time of extension.
- Name and address of borrower.
- Total credit amount that is to be drawn on and remain outstanding.
- Statement that you may demand repayment at any time. While there is no objective standard provided for determining the ability to demand, there is significant legal precedence in this regard.
- Collateral description (if secured).
- Maturity (date the commitment will mature).

**Committed Line of Credit**

A committed line of credit is an arrangement evidenced by a written agreement signed by you and the borrower in which you commit to advance funds on specific terms at their request. It is generally used when a customer has requested a credit line and you believe the customer is creditworthy and will continue to be creditworthy during the term of the approved credit line. A committed line cannot be demanded unless there is a breach of the terms and conditions of the written agreement, commonly referred to as a Default or an Event of Default.
Participation Agreements

A participation agreement is a written agreement between two or more lenders for the purchase by one or more lenders of an interest in a loan or loans originated by another. A participation arrangement usually includes:

- The terms of the arrangement between the lenders. It may be either a master agreement covering a series of loan transactions or an agreement covering a single loan transaction.
- A clause that specifies the order in which the originating lender or purchasing lender(s) will advance funds and the order in which the lenders will be repaid from payments received from the borrower. Possible repayment arrangements include the following:
  - **Pro rata**: Funds are advanced and repayment structured in proportion to the amount of the loan retained by the originating lender and the amount of the loan sold to the purchasing lender. This is the most common form of repayment.
  - **Bid/Auction**: A new development in the market is based on an auction, or bid structure, whereby lenders “bid” on the interest rates for loan advances, and the borrower has the right to select the lowest bid.
  - **First-in, First-out (FIFO)**: The originating lender advances its share first and receives payments up to its share before the purchasing lender is paid anything.
  - **Last-in, First-out (LIFO)**: The purchasing lender advances funds after the originating lender but is repaid first.
- A participation certificate is often used by the originating lender to show how much of the loan was sold to the purchasing lender.

**Important Considerations**

The seller of a loan participation makes no warranties or representations as to credit or documentation quality. If your institution is the buyer, it must independently analyze the creditworthiness of the borrower and review the documentation prepared for the loan.

To protect against the insolvency of the selling lender, you should insist that the participation agreement provide that any funds collected are held in trust for your institution based on your institution’s pro rata share.

A more complex type of participation arrangement is that which is often referred to as a loan syndication. The participation or syndication agreement used is more extensive and frequently names an agent lender for the credit arrangement. The agent lender’s duties are either included in the syndication agreement or in a separate agent agreement. Also included are provisions outlining participants’ rights to vote on various decisions and whether there will be direct contact with the borrowing entity. This agreement and other underlying loan documentation should always be reviewed by your legal counsel.
PERFECTING LIENS

In the following sections, we will explore topics on lien perfection:

- Basic Concepts Associated with Secured Loans
- Purchase Money Security Interests
- Landlord Waivers
- PPSA Definitions
- PPSA Collateral Perfection Chart
- Possessory Liens
- PPSA Filings
- PPSA
- Assets Not Covered by PPSA

Note that these concepts discussed in the context of the general intent of PPSA legislation. There are thirteen PPSA Jurisdictions in Canada that were all patterned after that same intent. While the concepts will be similar, you should ensure you understand the PPSA in your Jurisdiction. In reference to any legislation, infer it to mean “or the equivalent legislation in your Jurisdiction.”

Basic Concepts Associated with Secured Loans

When you enter into a security agreement, you are granted a “security interest” in property by the owner of the property. This means that in the event of default, you have the right to take the collateral in satisfaction of the debt or to sell it and use the proceeds to pay off the debt. Topics covered in this section about secured loans are:

- Attachment
- Perfection
- Rules for Establishing Priority Between Two Secured Parties
- Improving Priority Position
- Purchase Money Security Interests
- Landlord Waivers

Attachment

The PPSA provides that a security interest attaches to collateral when three conditions have been met.

- The debtor or third party grantor must sign a security agreement. You may also take possession of the collateral.
- The debtor or third party grantor must have "rights" in the collateral. It is generally easy to establish such rights because the debtor either owns the property when the security agreement is signed or will acquire it from a seller.
The lender must give "value" for the collateral. Value given means that the lender makes the loan, issues a letter of credit, or makes credit available whether or not it is drawn upon. A lender also gives value when it has a right to call a loan and foregoes that right in exchange for a new security interest. If, for instance, a customer had violated terms of a loan agreement, either by not making required payments or otherwise defaulting, you would have the right to terminate the credit transaction and demand payment. If instead, you accepted additional collateral and allowed the credit to continue, you would have given value as required under the PPSA.

**Perfection**

Although a lender has an attached security interest by meeting the three conditions necessary for attachment, there may be other creditors with claims against the same property. In most cases, the lender wants a claim that is superior to all others. To achieve priority against third-party claims, the lender must “perfect” its security interest before any other lender takes and perfects a security interest in the same collateral. Your priority position determines whether you will have a senior or junior right to collateral as related to rights of other lenders.

Methods of perfection include:

- **Perfection by Possession (Possessory Liens):** The easiest, simplest, and most effective way to perfect a security interest is by possession. The borrower or third-party grantor of a security interest delivers the collateral to you and you hold the collateral until the loan is repaid.

- **Perfection by Filing (PPSA Filings):** The PPSA specifies the method for giving notice of a security interest. This entails filing financing statements in one or more public offices.

- **Perfection by Compliance with Other Statutes:** For some types of collateral, including real estate, it will be necessary to file documents in compliance with other statutes such as Land Titles as PPSA does not cover real property.

- **Temporary Perfection:** Some types of collateral involve automatic perfection when the security interest attaches to the collateral. But the automatic perfection expires after a period of time. Then, unless the security interest is perfected by some other method, perfection lapses.

- See the PPSA Collateral Perfection Chart for a summary of PPSA rules.
Rules for Establishing Priority Between Two Secured Parties

- The PPSA sets forth complex rules for establishing priorities for many different applications. The rule most applicable for documentation purposes is the one that governs conflicting security interests in the same collateral. In general, the following outlines priorities between two secured parties:

  - Where security interests are perfected by registration, the order of registration determines priority, regardless of the order of perfection.
  - Where one security interest is perfected by registration and one otherwise than registration:
    - The registered interest has priority if it occurred before perfection of the other security interest;
    - The security interest perfected otherwise than registration will have priority if it was perfected first.
  - Where security interests are perfected other than registration, the priority will be in the order of perfection.
  - Where the security interests are unperfected, priority is determined in the order of attachment.

- Agriculture has a somewhat different priority structure. According to the PPSA, states:

  - “A perfected security interest in crops or their proceeds, given not more than six months before the crops become growing crops by planting or otherwise, to enable the debtor to produce the crops during the production season, has priority over an earlier perfected security interest in the same collateral to the extent that the earlier interest secures obligations that were due more than six months before the crops become growing crops by planting or otherwise even though the person giving value has notice of the earlier security interest.”

Here are some examples of the application of the general priority rule.

- **Example 1.** A files against X (debtor) on February 1. B files against X on March 1. B makes a non-purchase money advance against certain collateral on April 1. A makes an advance against the same collateral on May 1. A has priority even though B’s advance was made earlier and was perfected when made. A filed first.

- **Example 2.** A and B make non-purchase money advances against the same collateral. The collateral is in the debtor’s possession and neither interest is perfected when the second advance is made. Whichever secured party first perfects its interest (by taking possession of the collateral or by filing) will take priority.

- **Example 3.** Lender A has perfected a security interest in the inventory of a diamond merchant by filing on March 4. On April 15 of the same year, Lender B takes possession of ten diamonds from the merchant’s inventory. Lender A has priority because it perfected first. In this case, Lender B’s possession does not gain priority for Lender B because Lender A has perfected first by filing.

You should perfect your security interest as quickly as possible in order to obtain a first priority position. When perfection is by filing, this is best accomplished by filing prior to the closing.
**Improving Priority Position**

The collateral offered by the borrower may already be subject to the security interest of another creditor. Most likely the other creditor will have priority over your interest. In such an event, you should attempt to obtain a waiver or a subordination of the other creditor’s rights.

If you are refinancing a prior debt held by another creditor, you should require the other creditor to terminate any existing collateral filings. This type of transaction frequently results in a timing issue, that is, the prior creditor will not want to terminate its filings until it has been paid and you will not want to advance funds until you are certain that the prior creditor has terminated its filings. One method to resolve this issue is to have the prior creditor represented at the closing. The prior creditor can then receive the payout of its credit at the same time you receive the prior creditor’s termination statements. If the prior creditor is not available at closing and the transaction is a large one, the closing documents could be placed in escrow with suitable instructions to the escrow agent.

**Purchase Money Security Interests**

A purchase money security interest exists when the proceeds of the secured loan are used to acquire the collateral. The rules on purchase money security interests are an exception from the "first to file" rule. As a purchase money secured party, you have a special priority over other parties who may have an earlier perfected interest in the borrower's after-acquired property. This only applies to property financed by you and named on a properly filed PPSA financing statement.

If you have a security interest in collateral other than inventory, and can prove that you financed its purchase and have followed the PPSA perfection rules for purchase money security interests, you have priority over a conflicting security interest in the same collateral. You must perfect the purchase money security interest by filing a PPSA financing statement no later than a specified time period based on your Jurisdiction, but usually 15 days after the debtor receives possession of the collateral. Regardless of the 10-day grace period provided, you should file as soon as possible. You should obtain and keep proof that your funds were used to purchase the goods, preferably by making direct payment to the seller of the collateral, as well as proof of the delivery date for the goods.

The rule applying to inventory is different. You have priority over the conflicting security interest provided you give written notice to known or filed secured parties before any of the inventory is delivered to the debtor and perfect your security interest at the time the debtor obtained possession. The notice must state that you have acquired, or will acquire a purchase money security interest in the inventory and identify it by item or type. You must also be able to prove that you financed the inventory purchase.

**Landlord Waivers**

In some Jurisdictions, a landlord has an automatic lien for unpaid rents against the property of the tenant that is located on the rented premises. The landlord’s lien may have precedence over a previously granted security interest. Even in Jurisdictions where statutes do not provide for a landlord’s lien, the lease may give the landlord an interest in the property to satisfy unpaid rents. You should obtain a waiver, disclaimer or subordination of the interest of the landlord in the property of the tenant to permit entry into the leased premises and repossession of the collateral in the event of default.
PPSA Definitions

Terms used in the PPSA have special definitions that are technical and complicated but are essential to compliance with provisions of the PPSA with regard to the granting, attaching and perfection of security interests. As previously discussed, there are several PPSA jurisdictions, and while the following definitions are from the PPSA of Ontario, definitions in other jurisdictions are similar and have the same intent. You should ensure you understand the PPSA in the Jurisdiction in which you are doing business. Included are the following:

**Accession**: Goods that are installed in or affixed to other goods.

**Account**: a monetary obligation not evidenced by chattel paper, an instrument or security, whether or not the obligation has been earned by performance.

- **Chattel paper**: means one or more than one writing that evidences both a monetary obligation and a security interest in, or a lease of, specific goods. Examples would include equipment leases, conditional sales contracts (dealer paper) and promissory notes when the notes are secured by a security agreement covering goods or goods and software used in the goods. The chattel paper can be either tangible chattel paper (written chattel paper) or electronic chattel paper.

- **Consumer goods**: means goods that are used or acquired for use primarily for personal, family or household purposes.

**Debtor**: A debtor means a person who owes payment or performance of the obligation secured, whether or not that person owns or has rights in the collateral, and includes

  a) An assignor of an account or chattel paper, and  
  b) A transferee of or successor to a debtor’s interest in the collateral.

- **Equipment**: means goods that are not inventory or consumer goods.

- **Financing change statement**: means the information required for a financing change statement in the required form or format.

- **Financing statement**: means the information required for a financing statement in the required format.

- **Goods**: means tangible personal property other than chattel paper, documents of title, instruments, money and securities and includes fixtures, growing crops, the unborn young of animals, timber to be cut, and minerals and hydrocarbons to be extracted.

- **Instrument**: means.

  a) A bill, note or cheque within the meaning of the Bills of Exchange Act (Canada) or any other writing that evidences a right to the payment of money and is of a type
that in the ordinary course of business is transferred by delivery with any necessary endorsement or assignment, or

b) A letter of credit and an advice of credit if the letter or advice states that it must be surrendered upon claiming payment thereunder,

But does not include a writing that constitutes part of chattel paper, a document or title or a security.

- **Intangible**: means all personal property, including choses in action, that is not goods, chattel paper, documents of title, instruments, money or securities.

**Inventory**: Goods that are held by a person for sale or lease or that have been leased or that are to be furnished or have been furnished under a contract of service; or that are raw materials, work in process or materials used or consumed in a business or profession.

- **Money**: means a medium of exchange authorized or adopted by the Parliament of Canada as part of the currency of Canada or by a foreign government as part of its currency.

- **Obligation secured**: for the purposes of determining the amount payable under a lease, means the amount contracted to be paid as rent under the lease and all other amounts that have or may become payable under the lease including the amount, if any required to be paid by the lessee to obtain full ownership of the collateral, as of the relevant date, less any amounts paid.

- **Personal property**: means chattel paper, documents of title, goods, instruments, intangibles, money and securities and includes fixtures but does not include building materials that have been affixed to real property.

- **Proceeds**: means identifiable or traceable personal property in any form derived directly or indirectly from any dealing with collateral or the proceeds therefrom, and includes any payment representing indemnity or compensation for loss of or damage to the collateral or proceeds therefrom.

- **Purchase**: includes taking by sale, lease, negotiation, mortgage, pledge, lien, gift or any other consensual transaction creating an interest in personal property;

- **Purchase Money Security Interest**: means
  
a) A security interest taken or reserved in collateral to secure payment of all or part of its price or,
  
b) A security interest taken by a person who gives value for the purpose of enabling the debtor to acquire rights in or to collateral to the extent that the value is applied to acquire the rights,

But does not include a transaction of sale by and lease back to the seller.

**Secured party**: means a person who holds a security interest for the person’s own benefit or for the benefit of any other person and includes a trustee where the holders of obligations issued, guaranteed or provided for under a security agreement are represented by a trustee as the holder of the security interest and for the purposes specified sections (17, 59, 64, 66, 67) includes a receiver or receiver and manager.
• **Security**: means a document that is:
  - Issued in bearer, order or registered form,
  - one of a class or series or by its terms is divisible into a class or series of documents,
  - of a type commonly dealt in upon securities exchanges or commonly recognized in any area in which it is issue or dealt in as a medium for investment,
  - Evidence of a share, participation or other interest in property or in an enterprise or is evidence of an obligation of the issuer.
and includes an uncertificated security within the meaning of Part VI (Investment Securities) of the *Business Corporations Act*;

• **Security agreement**: An agreement that creates or provides for a security interest and includes a document evidencing a security interest.

• **Security interest**: means an interest in personal property that secures payment or performance of an obligation, and includes, whether or not the interest secures payment or performance of an obligation, the interest or a transferee of an account or chattel paper.

• **Trust indenture**: means any security agreement by the terms of which a body corporate, with or without share capital and wherever or however incorporated,
  a) Issues or guarantees debt obligations or provides for the issue or guarantee of debt obligations and
  b) Appoints a person as trustee for the holders of the debt obligations so issued, guaranteed or provided for.

• **Value**: means any consideration sufficient to support a simple contract and includes an antecedent debt or liability.
### PPSA Collateral Perfection Chart

<table>
<thead>
<tr>
<th>Type of Collateral</th>
<th>Perfection Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts</td>
<td>File a Financing Statement.</td>
</tr>
<tr>
<td>Agricultural liens</td>
<td>File a Financing Statement.</td>
</tr>
<tr>
<td>Chattel paper</td>
<td>Take possession and/or file a Financing Statement. It is preferable to take possession and file a Financing Statement. Chattel left in the possession of a debtor can be sold to a buyer who is unaware that the purchase violates the rights of the secured party and who would take the chattel paper free of the security interest.</td>
</tr>
<tr>
<td>Deposit accounts</td>
<td>File a Financing Statement. Establish control over the account. If the account is with your institution, control is automatic. If the account is with another institution, enter into an agreement with that institution.</td>
</tr>
<tr>
<td>Documents</td>
<td>Take possession and/or file a Financing Statement. It is preferable to take possession and file a Financing Statement.</td>
</tr>
<tr>
<td>Electronic chattel paper</td>
<td>Either file a Financing Statement or establish control over the electronic chattel paper.</td>
</tr>
<tr>
<td>Equipment</td>
<td>File a Financing Statement. The description of Equipment varies with Jurisdiction and in order to ensure your security is perfected, you need to understand the peculiarities of the Jurisdiction in which you operate or register. For example, under Alberta PPSA, Equipment is not a suitable description, and must be further described as in “computer equipment”. “Equipment” that is held for sale is inventory, and “equipment” utilized in the business such as desks are considered to be “goods”.</td>
</tr>
<tr>
<td>Farm products</td>
<td>File a Financing Statement.</td>
</tr>
<tr>
<td>Fixtures</td>
<td>File an appropriate Financing Statement and a fixtures filing.</td>
</tr>
<tr>
<td>General intangibles, including Accounts Receivable</td>
<td>File a Financing Statement.</td>
</tr>
<tr>
<td>Negotiable Instruments</td>
<td>Take possession or file a Financing Statement. Possession is always preferred. Instruments left in the possession of a debtor can be sold to a buyer who is unaware of the security interest and would not be subject to it.</td>
</tr>
<tr>
<td>Inventory</td>
<td>File a Financing Statement.</td>
</tr>
<tr>
<td>Type of Collateral</td>
<td>Perfection Method</td>
</tr>
<tr>
<td>----------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Letter of credit rights</td>
<td>Establish control over the letter of credit rights by obtaining the consent to the assignment of the issuer or any nominated person, such as a confirming or negotiating bank. The consent of all such persons should be obtained.</td>
</tr>
<tr>
<td>Manufactured home</td>
<td>File a Financing Statement and a fixtures filing.</td>
</tr>
<tr>
<td>Money/Cash</td>
<td>Take possession.</td>
</tr>
<tr>
<td>Securities (physical Stocks/bonds)</td>
<td>Take possession or file a Financing Statement. Possession is always preferred. Securities left in the possession of a debtor can be sold to a buyer who is unaware of the security interest and would not be subject to it.</td>
</tr>
</tbody>
</table>

**Note:** All Jurisdictions in Canada are under PPSA legislation with the exception of Quebec. However, the Civil Code in Quebec has similar law but significantly different terminology. Check with your legal counsel.

**Perfection by Possession**

**Types of Collateral Perfected by Possession**

Types of collateral in which security interests are perfected by possession include goods and other types of collateral that are represented by a writing (piece of paper) whose delivery serves to transfer the claim. These include:

- Chattel paper such as conditional sales contracts and leases.
- Goods means tangible personal property (refer PPSA for exclusions);
- Instruments such as a letter of credit, bill, note or cheque.
- Securities such as share certificates in bearer form.
- Negotiable documents of title which refer to certain goods held in bailee’s possession, and
- Money or cash

but only while it is actually held as collateral.

**Types of Possession**

- **Actual Possession**
  
  When perfection is by actual possession, you hold the collateral. The stocks, bonds, chattel paper or notes pledged have been delivered and are in your collateral vault.

- **Constructive Possession: Brokerage/Trust Accounts**
When perfection is by constructive possession, a third party holds the collateral in an account owned by the borrower. You gain constructive possession by entering into a control agreement whereby the holder of the account agrees to honor your orders with regard to disposition of property in the account. Such accounts are usually held by brokerage firms but may be maintained in your own trust department.

**Documentation Requirements**

- Security agreement.
- Control agreement, if applicable.
- Financing Statement, if applicable.
- Documents necessary to transfer the collateral in case of default, if applicable. These include an endorsement of the instrument, assignments, and stock powers signed by the owner of the securities. If the instrument is a promissory note, the endorsement may be on an attached sheet of paper, which is called an allonge.

**Special Considerations**

- Book based securities or those that do not have physical certificates provide unique challenges and you should consult legal counsel in order to ensure your security interest is perfected.
- Legislation concerning Chattel Papers, for example, is regulated in the Jurisdiction in which the vendor is registered. If it is assigned to a financial institution that is federally regulated, the financial institution must comply with the regulations in the Jurisdiction in which the vendor is registered, not the Jurisdiction in which it is registered.

**PPSA Filings**

For practical reasons, the collateral frequently must remain with the debtor or third party grantor. There are several methods for perfecting a priority position other than by possession. Unless perfection is by possession, secured transactions law usually requires some form of public notice whereby third parties are advised of the interest of the secured creditor. PPSA filings are the chief method of providing such notice.

**Documentation Requirements**

- Security Agreement
- Financing Statement. Your security interest will normally be perfected by filing a financing statement with an appropriate public office. The purpose of filing a financing statement is to give public notice to other creditors that you claim an interest in the collateral.

**Assignment**

If a creditor has assigned its security interest to another creditor, the creditor would give public notice of the assignment by noting it and by filing a financing change statement.

**Amendment**

You may amend an existing financing statement by filing a financing change statement.
**Duration of Filing**

A financing statement generally is generally effective for the time period indicated on the financing statement. If you do not know the rules for the Jurisdiction in which you will be filing a financing statement, consult legal counsel.

**Continuation**

To continue perfection beyond the initial time period indicated, a financing change statement must be filed.

**Termination**

A debtor must receive a termination statement within 10 days of its request if the debt has been fully paid and no future advances are anticipated. There are penalties for failure to do so. The secured party would be liable to the debtor for a prescribed amount ($500 under the PPSA in Ontario) plus any damages sustained by the debtor. There may be additional requirements and/or different penalties in the Jurisdiction where you filed a financing statement. If you do not know the requirements in that Jurisdiction, consult legal counsel.

**Place of Filing**

The majority of PPSA Jurisdictions have the following rules for filing, but you should ensure it is appropriate for your Jurisdiction.

- Where the “debtor is located” includes:
  - Consumer goods;
  - Equipment of a type normally used in more than one jurisdiction (aircraft, moving vans, etc.);
  - Inventory leased to others in the normal course of business normally used in more than one jurisdiction;
  - Intangibles, including accounts receivable;
  - Securities where we do not take possession;
  - Chattel paper where we do not take possession of the contracts.

- Where the “goods are located” includes:
  - Consumer goods;
  - Equipment not included above.

- Where “wellhead or minehead is located:” include
  - Accounts receivable related to sales of oil and gas and other minerals at the wellhead or minehead.

“Debtor is located”

- At the place of business if he only has one;
- At the location of the chief executive office if he has more than one location;
- At the location of the personal residence if he has no place of business.
Other Filings

When perfecting a security interest in real property that may become a fixture (such as a mobile home), it is also necessary to file a notice in the appropriate Land Titles office. This is sometimes referred to as a fixtures filing. If the real property is to become a fixture on leased land you also require consent of the landlord to enter the premise and realize on security should there be a default.

PPSA Search

Before granting credit against collateral, you should confirm that no other lender has an existing perfected security interest in the same collateral.

For PPSA security you should search:

- In the location where you will need to registered your security, based on the previous section.

- Under prior names. It is not always the case that case that previous security has been discharged. If the previous lender was not aware of a name change, that security will still most likely be valid and take precedence to any new filing, even if under a different name.

For security under the Bank Act, you should search at the Bank of Canada.

Assets Not Covered by PPSA

The PPSA does not cover all types of assets. For assets not covered by the PPSA, other Jurisdictional laws set methods for taking and perfecting collateral interests. In the paragraphs to follow, we will discuss the following non-covered assets:

- Real estate
- Government contracts
- Ships
- Life insurance, but does cover property insurance.
- Trademarks and Tradenames.

Real Estate

A mortgage or fixed charge debenture is an agreement that grants a lien on real estate that secures repayment of a debt and gives the lender rights to the real estate in the event of default.

A mortgage is an agreement between two parties, a mortgagor and a mortgagee. The mortgagor is the party granting your institution an interest in real property to secure repayment of a loan. Your institution is the mortgagee. If the borrower does not repay the
loan, you can foreclose on the mortgage or under the debenture to obtain partial or full payment of the loan.

If you are taking a real estate mortgage interest, you must obtain answers to the following:

• Who owns the real property and what is the nature of that ownership?
• Are there interests in the real property, other than those of the prospective mortgagor or grantor, that could take priority over your lien?
• What interest in the real property will the mortgagor or grantor be granting to you—is it a mortgageable interest?
• What is the real property worth?
• Are there existing or future factors that could negatively affect the collateral value of the real property, such as environmental hazards, flood hazards, use restrictions, easement problems or encroachment problems? Easements are rights or privileges that a party may acquire over the land of another party. For example, utility companies have easements that allow them to install necessary lines on property that is privately owned. Encroachments are structures, such as a fence or wall, which are illegally situated in whole or part on the real property of another person. How can those hazards be avoided or mitigated?

Ownership

It is possible in some Jurisdictions to obtain title insurance, which protects against any undisclosed defects in the title to the property. In those instances, you should obtain a title insurance binder from a reputable title insurance agency representing a financially sound title insurance company. The binder will contain information as to the status of the title to the real estate and will enumerate steps you must follow to obtain a final title insurance policy in accordance with the binder.

You may also have to examine other documents referred to in the binder. You should direct any unanswered questions to an experienced real estate lender or your legal counsel. You must clear all unacceptable exceptions prior to closing.

When you do not have title insurance, you must conduct customary searches to determine ownership and you should be aware of the specific requirements of your Jurisdiction.
Types of ownership vary from Jurisdiction to Jurisdiction, but generally include the following:

- **Fee Simple Estate**
  A fee simple estate is one in which the owner(s) is entitled to the entire property, with unconditional power of disposition during the life or existence of that owner(s).

- **Leasehold Estate**
  A leasehold estate is an estate held under a lease for a fixed term. The estate ends when the lease terminates. You may discover that your real estate collateral is owned by your mortgagor but is on land that is not owned by your mortgagor. The collateral is subject to a ground lease, that is, the collateral is on leased land. You must obtain a copy of the lease agreement. Ask your legal counsel to review the lease to determine how it will affect your collateral value. Determine the length of the lease, whether it is assignable and what restrictions on land use are included. It is also advisable to obtain an agreement with the lessor to ensure the lease remains in effect. Things to consider including in that agreement include the ability of the lender to remedy a default under the lease if the lessee fails to do so.

- **Joint Tenancy**
  A joint tenancy involves ownership of real property by two or more persons. If the joint tenancy includes rights of survivorship, title passes to the surviving owner(s). If the joint tenancy is without rights of survivorship title of the deceased owner passes to the heir(s) of the deceased owner if one of the owners dies.

- **Tenancy in Common**
  A tenancy in common involves ownership of real property by two or more persons. A tenancy in common is always inheritable. If one of the owners dies, the ownership share of that deceased owner passes to the heir(s) of the deceased owner. A real estate deed to two or more persons as joint owners without any further express description is considered to establish a tenancy in common.

- **Homestead/Dower**
  Under modern law, homestead is an artificial estate in land devised to protect the possession and enjoyment of the owners against the claim of creditors. It withdraws the property from execution and forced sale as long as the land is occupied as a home. The extent of the homestead exemption and the methods for claiming it differ widely from Jurisdiction to Jurisdiction.
Title Insurance Policy

A title insurance binder is not a final title insurance policy. It is an agreement to issue a final title insurance policy in accordance with the terms of the binder if the conditions contained in the binder are met. Your institution should be named as the insured party on the final title policy. You or your legal counsel should carefully examine the final title policy before closing to make certain that it complies with any provision or instructions contained in the binder.

You must verify the legal description, the names of your institution and the property owner and the amount of coverage. The legal description must be identical on the title binder, title policy, mortgage or deed of trust and survey.

The title insurance company will not insure against undisclosed interests of parties in possession of the property. It will also not insure against encroachments that would have been disclosed by an accurate survey unless a survey has been provided to the insurer. A survey is the process by which a parcel of land is measured and its contents ascertained.

Assignable Interests

Every interest in real property is assignable, unless it is subject to a prior agreement not to assign. When the real property in question is subject to a lease, contract for sale, or is owned by a trust, you must examine the lease, the contract or the trust agreement to determine whether the borrower’s interest in the real property is assignable without consent of the other party(ies) to the prior arrangement.

Value

The most reliable methods for determining the value of real property collateral are evaluations and appraisals. Under OSFI, there is no legal requirement to obtain an appraisal and the decision as to whether an appraisal is required is left to the discretion of the financial institution.

Negative Valuation Factors

Factors that could have a negative impact on the value of real property collateral include:

- **Environmental Hazards:** You should perform or order an environmental assessment
- **Easement Problems:** Easements that exist in favor of parties other than the borrower could make the property less salable after a foreclosure.
- **Encroachment Problems:** Improvements on the potential real property collateral that encroach on adjoining real property or improvements on adjoining real property that encroach on the real property may reduce the value of prospective collateral. You can determine potential problems by obtaining a survey. You must deal with encroachment problems before the loan closing.
**Insurance**

Many factors that could negatively affect the value of your collateral and the ability of the borrower to repay its loan are unavoidable and cannot be insured against. For those factors that can be insured against; require proof that such insurance has been obtained and that your institution is an included insured party. Generally you prefer that your bank be named as loss payee under a Standard Mortgagor clause. It provides that your right to coverage under the policy would not be affected or defeated by any act, neglect or default of the borrower.

Types of insurance required vary depending upon the type of loan transaction.

**Government Contracts**

The Financial Administration Act of the Jurisdictions outline the conditions for assignment of government contracts based on the type of contract and the Jurisdiction in which it is located.

**Ships**

The proper method to take and perfect a security interest in a boat depends on the kind of boat involved in the transaction. If the boat is for commercial purposes, and in excess of fifteen tons, it must be registered under the Shipping Act which permits mortgage security on those vessels. If the ship is not registered under the Shipping Act it may be possible to take security under the PPSA. You should consult legal counsel to determine where the ship is or should be registered and where appropriate searches should be conducted.

**Life Insurance**

Perfection of collateral interests in life insurance is also not covered by the PPSA. When life insurance is pledged as collateral, you hold the policy and forward a notice of the assignment to the insurance company for recording and acknowledgment. Only the owner of the policy can provide a pledge.

**Documentation Requirements**

- Life Insurance Assignment Questionnaire: This is used to verify information on a life insurance policy in which you intend to take a security interest. The insurance company completes most of the questionnaire. This must be done before the assignment is taken.
- Assignment of life insurance policy. Take three copies. Retain one and mail two to the insurance company, which will acknowledge one and return it to you.
- Life insurance policy (held by you).
- Release of Assignment of Life Insurance Policy (policy should be returned, also). This is sent to the insurance company after the loan has been repaid.

**DOCUMENTING THIRD PARTY SUPPORT**

Frequently a credit cannot stand on its own. That is, a company’s ability to repay does not qualify it for the amount of credit requested. The lender may make the loan, but will require third party support to enhance chances of repayment. In the following paragraphs, we will review the following types of third party support:
Guaranties

A guarantee is an unconditional promise of payment or performance by one party on behalf of another. It may be enforceable even if the person who borrowed the money has a legal reason not to pay. Guaranties may be:

- **Unlimited in amount.** Such a guarantee would cover all indebtedness of an entity to you.
- **Limited as to amount.** Such a guarantee would cover all indebtedness of an entity to you up to a maximum stated amount.
- **General as to indebtedness covered.** Such a guarantee would cover all indebtedness of an entity to you, however such indebtedness was incurred.
- **Specific as to a particular loan.** Such a guarantee would cover only that indebtedness of an entity to you that was specifically described in the guarantee.

Lenders ordinarily prefer the use of a general guarantee in an unlimited amount, the basic provisions of which include:

- **Parties’ names.** Your institution, the borrower and the guarantor(s) would be named. You must be certain that all names are complete and correct.
- **Description of consideration for the guarantee.** A guarantee is a contract. All contracts must be supported by consideration. Consideration is either something received by the party(ies) signing the guarantee or some other person or entity as desired by the signing party(ies). For example, the guarantee might provide the following: “For good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, and to induce (the Lender), at its option, at any time or from time to time to make loans or extend other accommodations to or for the account of (the Borrower)…”
- **Description of obligations guaranteed.** This provision would either state that all indebtedness of the borrower or specially named obligations were guaranteed.
- **Default provisions.** The guarantee would list covenant events that would cause a default under the guarantee.
- **Waiver of defense provisions.** The guarantee would list legal reasons why a guarantor might have not to pay on the guarantee and provide that they would not be used by the guarantor.
- **Limitation of liability.** The guarantor’s liability would be described as unlimited or a stated maximum.
• **Description of security for the guarantee.** It would be indicated either that the guarantee was unsecured or was secured by certain named collateral.

• **Guarantor's covenants.** If appropriate, covenants would be included if needed to protect the lender's interest.

It is important that you be able to explain the consequences of signing the guarantee. For help in evaluating the financial resources of an individual guarantor see Personal Statement Analysis in *Dimension 3*.

### Collateral Agreements

A third-party security agreement (sometimes called a hypothecation agreement) or mortgage is an agreement by someone other than the borrower to provide the collateral for the loan. In order for the security agreement to be legally binding, it must be provided in support of a guarantee.

*Example:* Two companies exist under common ownership. Company A needs to borrow funds from you but does not have sufficient collateral to secure the loan. Company B has unencumbered assets consisting of accounts, equipment and inventory. If Company B is willing, it could grant you a guarantee supported by security interests in its assets to secure your loan to Company A.

### Collecting from a Guarantor/Third-Party Security Interest in Event of Default

In order to ensure your guarantee remains valid you must notify and obtain consent from the guarantor for any act, default or change of terms and conditions which could increase the risk of default of your borrower and therefore increase the risk to the guarantor. Failure to do so in some circumstances could invalidate the guarantee.

You should also be aware of specific provisions for guarantors within your Jurisdiction. For example, in Alberta there are specific guidelines under the Guarantees Acknowledgement Act and in Saskatchewan there are regulations under the Saskatchewan Farm Act which must be followed in order for the guarantee to be legally binding.

### Comfort Letters

Comfort letters are letters issued to lenders by companies to indicate support for another entity borrowing from the lender. They are sometimes offered and accepted in lieu of guarantees. They are most often issued by parent companies in connection with subsidiary borrowings. They generally fall short of an absolute promise to pay the borrowing entity’s debt. Companies that favor comfort letters are generally public companies that do not want to have to include contingent liabilities in their financials.

Comfort letters are enforceable, depending on the language used in the document. They are an adequate substitute for guarantees only if they contain a solid commitment of the issuer to step up to repayment obligations incurred by its subsidiary. You should attempt to find out how the issuer has performed under similar previous arrangements.
Documentary Letters of Credit

A documentary letter of credit (sometimes called a commercial letter of credit) is issued on behalf of a customer in favor of a third party where the issuer is to make payment when the issuer is presented with a draft accompanied by documents specified in the letter of credit. This type of letter of credit most commonly originates in international trade situations.

Example: A Canadian buyer wants to purchase furniture from an Italian manufacturer (seller). The Italian manufacturer will not sell on credit, and the Canadian buyer will not pay in advance. Under a letter of credit agreement, the seller puts the furniture on board a carrier and receives a negotiable bill of lading. The seller presents the bill of lading and other agreed-on documents to the buyer’s financial institution, the issuer of the letter of credit. The buyer’s institution pays "cash" on presentation of the documents, although the furniture is still en route. If the carrier should fail to deliver the goods, the carrier would be liable for non-delivery.

Relationships of the Parties in a Documentary Letter of Credit

Account Party (Buyer) and Issuing Bank:
- The relationship is a contract usually embodied in the letter of credit application.
- The issuing bank must examine documents with care to ascertain if they comply with the letter of credit.
- Unless otherwise agreed, an issuing bank that has duly honored a draft is entitled to immediate reimbursement.
- If the account party does not pay after the issuing bank has honored a draft, the issuing bank owns the goods.

Account Party (Buyer) and Beneficiary (Seller):
- The relationship is usually contractual in nature, underlying the letter of credit and independent of it.

Issuing Bank and Beneficiary (Seller):
- The relationship is a contract embodied in the letter of credit.
- An issuing bank must honor a draft that complies with the terms of the letter of credit regardless of whether the documents or goods conform to the contract between the Account Party (Buyer) and the Beneficiary (Seller). Also, if the account party goes bankrupt after the letter has been issued, payment must still be made to the Beneficiary if the Beneficiary meets the requirements of the letter of credit.

Confirming Bank and Issuing Bank
(Not Included in the Documentary Letter of Credit Flow Diagram):
- A confirming bank takes on the same obligation as an issuing bank.
- A confirming bank is required by a beneficiary when it is not satisfied with letters of credit issued by the issuing bank. This can occur if the issuing bank is too small relative to the
size of the transaction, or the issuing bank has a bad reputation with regard to honoring its letter of credit obligations.

- By confirming a credit, a confirming bank becomes directly obligated on a letter of credit to the extent of its confirmation as though it were the issuer and acquires the rights of the issuer.
- The confirming bank obtains reimbursement from the issuing bank after a drawing is made under the letter of credit.

**Advising Bank:**

The advising bank assumes no liability except for accurate transmission of information between the beneficiary and the issuing or confirming bank.

**Documentation Requirements**

A letter of credit is usually issued by your international department. It must be in writing and signed by the issuer. A telegram is considered the operative letter of credit if it identifies its sender by an authorized authentication. However, a teletransmission is not considered a signed letter of credit if it states "details to follow" or words to that effect.

The following forms must be completed for a letter of credit to be issued:

- An application and an agreement for a letter of credit prepared by the customer. It usually contains language equivalent to that in a promissory note. If so, no note is needed.
- A letter of credit prepared by your international department.

**To Amend a Letter of Credit**

An Amendment to Letter of Credit must be completed by the customer requesting the Letter of Credit and signed by the issuing bank and the beneficiary.

**Assignment of Letter of Credit Rights**

If you are taking an assignment of the beneficiary’s rights under the letter of credit as collateral, you must perfect that security interest by gaining control of the rights. Establish control over the letter of credit rights by obtaining the consent to the assignment of the issuer or any nominated person, such as a confirming or negotiating bank. The consent of all such persons should be obtained.

**Standby Letters of Credit / Direct Pay Letters of Credit**

A standby letter of credit or a direct pay letter of credit is a written engagement between a customer and the lender. It provides that the lender will honor demands by a third party for payment upon the third party's compliance with specified conditions. The fewer conditions, the better. The strongest letter of credit would be one requiring only a demand for payment. It is issued on behalf of a customer in lieu of a guarantee to protect a third party in the event the customer fails to perform under a contract between the customer and the third party. Payment is made against a written statement from the third party of the customer's failure to perform. Usually, the issuer does not expect to fund a standby letter of credit.
Example: A construction company applies for a standby letter of credit that acts as a “performance bond” in case the construction company fails to complete the work on time or as detailed in the work specifications.

Parties to the Arrangement

- **Account Party**
  The account party is the customer applying for a letter of credit. The account party agrees to pay the issuer a fee for this service and to immediately reimburse the issuer for payment made under the letter of credit.

- **Issuer**
  The issuer is the party issuing a letter of credit.

- **Beneficiary**
  The beneficiary is the party in whose favor the credit is issued.

- **Confirming Bank**
  A confirming bank is a bank that undertakes the same obligations assumed by the issuer. This may be required when the issuer bank is for some reason not acceptable to the beneficiary.

- **Advising or Notifying Bank**
  An advising or notifying bank is usually a bank or other financial institution at the beneficiary’s place of business that undertakes responsibility for transmission of information and the authentication of information.

- **Paying Bank**
  A paying bank is a bank or other financial institution in the beneficiary’s locality that is designated to issue payment when the issuer and the beneficiary are at some distance. Often the paying bank is also the advising bank.

- **Transferee or Assignee**
  A transferee or assignee is a party to whom the beneficiary has transferred or assigned the right to perform all or some of the conditions of the credit and to demand and receive all or some of the payments.

Assignment of Letter of Credit Rights

If you are taking an assignment of the beneficiary’s rights under the letter of credit as collateral, you must perfect that security interest by gaining control of the rights. Establish control over the letter of credit rights by obtaining the consent to the assignment of the issuer or any nominated person, such as a confirming or paying bank. The consent of all such persons should be obtained.

Subordination Agreements

A subordination agreement is an agreement between two or more creditors. In structuring a loan transaction, you may encounter creditors whose claims are senior to your claims. These claims must be subordinated to your claims in order to assure that you will have first right to...
payment. A subordination can pertain to either an existing debt or to a collateral position. Other creditors may include:

- Principals of the borrower who have injected capital into the borrowing entity in the form of loans rather than equity.
- A venture capitalist or other third party whose investment is represented, in part, by debt rather than by some form of equity instrument.
- A creditor who has claimed and perfected a lien position against the business assets.

Subordination agreements dealing with debt differ as to what, if any, payments will be permitted during the term of your debt. The agreement may do any of the following:

- Prohibit all payments on the subordinated debt until your debt has been repaid in full.
- Permit scheduled payments of interest only on the subordinated debt until there is an event of default, then prohibit all payments until your debt has been repaid in full.
- Permit scheduled payments of principal and interest on the subordinated debt until there is an event of default, then prohibit all payments until your debt has been repaid in full.

Subordination agreements dealing with collateral may cover all of or only a portion of the subordinating creditor’s collateral position.

**Intercreditor Agreements**

An intercreditor agreement is an agreement between two or more creditors. In structuring a loan transaction, you may encounter creditors whose claims are equal to or senior to your claims. For example, you may be providing floor plan financing for an automobile dealership that is also receiving new vehicle financing from a manufacturer. These split-financing arrangements can result in expensive court battles unless agreement on collateral rights is reached among the competing creditors.

The intercreditor agreement should describe specifically the collateral financed by each creditor. It should also provide that each creditor would have a senior position as to collateral financed by that creditor, even if that creditor had perfected its security interest later in time than other parties to the agreement. The agreement should also provide for distribution among the secured parties in the event of bankruptcy or other insolvency proceedings.

You should have intercreditor agreements drafted or reviewed by your legal counsel.
Closing Procedures

There are two main factors that determine whether a loan closing will be successful. They are:

- Adequate preparation prior to the closing
- Firm management of the actual closing process.

To adequately prepare for a closing, you or your support staff must:

- Prepare a closing memorandum or detailed loan documentation checklist.
- Provide sufficient time for the borrower and any other parties involved in the transaction to gather documents.
- Provide the borrower and any other parties instructions on how to complete standard documents and ensure that they return the forms to you for review prior to the closing.
- Prepare drafts of loan documents and deliver them to the borrower or other involved parties prior to the closing with sufficient time for the recipients to have the documents reviewed by their own legal counsel.
- Submit any document changes requested to your legal counsel for review to determine whether making the requested changes would have legal consequences.
- Submit documents such as operating agreements, partnership agreements and trust agreements to your legal counsel for review and opinion.
- Set a date and time for closing that provides time for preparation and attendance by all necessary parties.
- Provide a sufficient number of copies of each loan document required for closing.

Good management of the closing process requires that the closer:

- Select an appropriate location for the closing. A good location is a conference room at your institution with a table large enough to permit the closing documents to be sorted into separate stacks, arranged in the order in which they will be approved or signed.
- Make certain that all of the parties necessary to the closing are gathered in the same place at the same time. Choose a day and time of day that is convenient for all of the parties. If a wire transfer will be included as part of the transaction, make certain that your closing is scheduled early enough to allow for completion of the transfer before close of business.
- Insist that the borrower and other appropriate parties produce all required documents for which they are responsible before the closing begins. The documents must be reviewed and approved and the documentation checklist or closing memorandum marked accordingly.
- Make certain that all necessary parties sign all of the documents that require execution, and that portions of documents that require initials of the parties are properly initialed.
Assure that each executed document is reviewed for completeness and accuracy. Where staffing permits, one person should facilitate the circulation of documents to the signers and another examine each document after it has been signed. Make certain that appropriate disbursement procedures have been followed. This may involve obtaining wire instructions, cashier’s cheques, or the completion and delivery of account deposit slips.

Make certain that all necessary parties stay until all documents have been completed, reviewed and approved.

Note: The best time to obtain a complete loan documentation package is prior to disbursement of loan proceeds. It is generally more difficult to correct loan documentation deficiencies after funds have been disbursed and the parties to the closing have left.

Custom versus Standard Documentation

Many banks use standard loan documents, which may be prepared by in-house counsel, a designated department or sometimes through the use of an automated loan documentation software product. Each institution has internal guidelines that determine when custom documents must be prepared. Common considerations for custom vs. standard documentation include:

- Transaction size considerations. Your institution may have a transaction dollar amount above which custom documentation is required.

- Availability of compliance warranty from standard documents. Some vendors of computer prepared loan document packages provide compliance warranty protection to a certain transaction amount. In other words, the vendor will reimburse the bank for costs incurred to enforce the terms of documents if they are attacked based on the way the loan has been documented. Beyond a maximum transaction size, warranty protection is typically not available, and this protection limit may influence your bank’s designated loan size requiring custom documents.

More important, however, is to keep in mind that changes to the standard documentation package outside the scope of built-in, allowable documentation options may void any compliance warranty. If a transaction includes negotiated changes from standard document language, it is vital to check with your bank’s legal counsel to determine if custom documents are required.

- Ability to pass documentation costs to the borrower. Many banks reserve in-house counsel resources for documentation review instead of documentation preparation. It may be difficult to pass through documentation preparation expense if the work is performed by in-house counsel.

- Complexity of the transaction. Standard documents may not be ideal or even adequate if the transaction or the borrowing entity is complex. Certain entity types, such as a complex trust, or transaction elements such as assignments or guarantees from complex entities may require custom documents. Unusual issues such as loans secured by intellectual property may similarly require custom documentation.
• Sophistication of the borrower. Sophisticated borrowers that will have an attorney represent them may make negotiation of loan document language a ‘deal breaker.’ If that is the case, it can be dangerous for the bank to have the lender alter standard documents. Customized documentation is generally the safest response to such a borrower request.

• Bank’s ability to service non-standard documents. Often, banks’ loan servicing organizations are configured to support standard loan requirements as documented in the standard loan agreement. If custom servicing provisions are negotiated (such as an unusual window of time to submit financial statements or an unusual cure period for a loan covenant), the bank must have procedures in place to deviate operationally from the standard provisions. Custom-documenting a loan may introduce enforcement risk if the bank’s servicing department is not flexible enough to consistently and accurately enforce loan document provisions that deviate from the norm.

• Whether the bank will sell or securitize the loan. Standard documents make it easier to sell, securitize and participate loan transactions. Non-standard documents may require additional attorney work to package them for these purposes.

In all cases, it is critical to understand your institution’s policies regarding the choice of custom versus standard loan documents. You should not alter or agree to alternations of standard documents outside the parameters of pre-approved documentation options without seeking counsel’s advice.
Identifying and Mitigating Environmental Risk

There has been an increased awareness of the need to protect our environment from contamination and ecological harm. Attention is being paid to environmental problems by government, business, and civic groups. Environmental contamination can arise from:

- Pesticides
- Poisons
- Solvents
- Petroleum products
- Industrial chemicals
- Animal by-products and waste
- Metal fragments
- Building materials

Government authorities, in conjunction with the business community and civic groups, have responded by developing stringent guidelines for handling hazardous substances and other wastes. Severe financial and criminal penalties can be imposed on individuals or businesses found guilty of contaminating the air, land, or water.

The costs associated with the cleanup and remediation of a contaminated site can be exorbitant, even to the point of crippling the financial capacity of an individual or business. For this reason, prudent lending practices require that you determine if actual or potential contamination exists on a property that you intend to finance or use as collateral. Prior to realizing on existing security, you must ensure that there are no environmental issues associated with it as under most conditions, your financial institution will become liable for the clean up of contaminated property.

What if the very nature of a borrower’s business entails working with hazardous substances or creates hazardous material as a by-product of the manufacturing process? Again, most manufacturers and some other industries have some involvement with hazardous materials or by-products from their production process. These companies can still be good customers if you take the following precautions:

- Your customer should issue an environmental indemnification that states the company is aware it handles hazardous materials and agrees to follow accepted procedures in its handling of those materials.
- Loan documents should contain an environmental rider that contains similar language and outlines your institution’s remedies in the event your customer violates the accepted procedures.

The intent of this section is to help you understand the complexity and severity of environmental issues. Solicit professional help when trying to evaluate the risks of environmental issues and in documenting loans. Several tools are available to help protect your institution against environmental liability.
ENVIRONMENTAL AUDIT

The environmental audit is one way to help insulate you and your borrower from risk. It alerts all parties to a transaction of the potential for liability. Several levels of review have become accepted practice:

- A checklist that might be performed by you or by a qualified individual on your institution’s staff
- A soil and/or water testing coupled with the documentation of detailed remediation procedures performed by a third-party environmental engineering firm.

Checklist

Your institution’s credit policy manual should contain an environmental policy that provides a checklist to be completed for all credits (usually above a certain dollar limit) that is placed in the company’s credit file. The process includes asking questions of owners and occupants of the property, observing site conditions at the property, and conducting limited research regarding certain government records and historical sources. If answers reveal suspicion of contamination, the next level of inquiry is required.

Environmental Audits

There are three levels of environmental audits.

Phase I

Warranted whenever there is reason to suspect contamination, based on a checklist inquiry from your environmental policy.

Phase II

Warranted whenever the Phase I assessment indicates evidence of contamination. In this phase, soil and groundwater samples are taken and tested to determine the actual extent of contamination, if any.

Phase III

Consists of remediation procedures for contamination discovered and confirmed in Phases I and II. The Phase III audit report spells out the full extent of the contamination, what the mitigation procedures must be, and the costs expected to be incurred in the cleanup.
Risks Associated with Environmental Law Infractions

If you suspect any environmental problems, however minor, solicit professional help!

There are two major risks associated with environmental law infractions:

- Environmental infractions can compromise a borrower’s creditworthiness.
- Contamination can negate the value of your borrower’s collateral.

The following Signals of Environmental Problems: Things to Identify and Consider (SEPTIC) will help you as you visit your customer’s facilities. While you tour a site, ask what substances were or are being used on the property and the by-products from the company’s operations. Keep your mind open to all possibilities, ask lots of questions, and don’t be reluctant to challenge answers.

The SEPTIC list is a partial list of environmental prompts which, when accompanied by your organization’s environmental and credit policies, will guide your observations.

Financial institutions are often viewed as the “deep pockets” in a transaction and have been found to be financially responsible for site cleanup expenses by virtue of having taken a security interest in, or financed the acquisition of, a property that was or has become contaminated. You need to be very wary of any transaction that might involve a contaminated property. How do you protect yourself? If a hazard is discovered, you and your borrower can simply choose not to become involved with the transaction. If you choose to pursue a transaction that involves an environmental issue then you must solicit expert environmental and legal assistance.
Dimension 7: Identify and Develop Strategies for Problem Loans
Purpose of Dimension 7

The purpose of Dimension 7 is to describe early signals of problem loans and to review appropriate responses to those signals. In Dimension 7 we will cover the following topics:

- Financial and non-financial warning signs
- Account management alternatives for problem loans
- Gathering information about the problem loan
- Developing problem loan strategies
- Bankruptcy considerations
- Lender liability issues

Introductory Note

Dealing effectively with problem loans requires early detection. Any number of events can alert you and your borrower to a problem. The warning of a problem loan may come as a surprise, or as a result of a slowly deteriorating credit. Either way, when it occurs, you should immediately shift into your institution's problem loan procedures. Each institution has its own process, and it is not the intent of this section to suggest that one procedure is better than another. In Dimension 7 we present certain steps that are common to most problem loan approaches.

Warning Signs

Nothing can be more chilling than to have a borrower walk into your office, hand over the keys to the plant, and say that they are unable to continue the operation. If the problem is a surprise, due diligence before funding and the subsequent monitoring of the loan were ineffective. (Due diligence, a term borrowed from the investment community, applies to the efforts of the analyst to identify the key issues of the credit.) The most important tool in detecting a problem loan is ongoing monitoring of the credit.

Early identification of a problem loan may be documented through your risk-rating system or through the process of putting the company’s name on a watch list. Watch-listed credits are generally not those in imminent danger of bankruptcy. They may be identified as watch-listed because the company has changed management or is in a certain industry experiencing economic difficulty.

The earlier you can detect a potential loan problem, the more likely it is that you will successfully deal with the problem.

Appearance of a warning sign does not always mean that the loan has or will become a problem. It does indicate, however, that you should ask questions.

The causes of the problem could be financial or non-financial or some combination of both.

Financial Causes

Your first warning of company problems is likely to come from financial factors. Early warning signs of company problems based on financial causes could include any or all of the following:
• Late Statements
• Frequent Overdrafts
• Covenant Violations
• Late Payments
• Overadvances
• Deteriorating Trends

Late Statements
• Is this a new event?
  ➢ If so, you should find out why the statements are late and look for other warning signs. This may indicate that the company is delaying production of financial information because it has bad news to report.

• Is the company slow in providing other requested information?
  ➢ This may signal deterioration in the borrower-lender relationship.

• Have you responded properly to late statements?

• When statements or other information are late, you can call the loan, extend the time for compliance or suggest changes in reporting requirements. Never ignore the breach. If you decide to call the loan, consult with your legal counsel first. How you initially respond could set a course of dealing with the company that could limit your options when subsequent violations occur.

Frequent Overdrafts
Overdrafts are signs of deterioration in the company’s cash position. Overdrafts are unauthorized, undocumented and often unsecured loans. This is frequently the earliest indicator of a troubled company. Unfortunately, by the time the lender is directly affected, the company may already be in trouble. This may be a warning that the company has poor cash management, a lack of working capital or a growing held-cheque problem. You should track monthly average collected balances to see if there are cyclical trends or a pattern of overdrafts. It is important to ask questions early to prevent problems and avoid losses. Questions you might ask include the following:

• Is this a new event?

• Are the overdraft items written to suppliers? If so, this could signal a deterioration of supplier relationships.

• Are the overdraft items written to the Canada Revenue Agency (CRA)? If so, this could signal serious tax problems and lead to potential lender liability for unpaid taxes.

• Have you properly responded to overdrafts? Never ignore overdrafts. How you respond could set a course of dealing with the company that could limit your options when subsequent overdrafts occur. Unless there are extenuating circumstances, and you have the approval of your credit department, the cheques creating the overdraft should be returned as not sufficient funds (NSF).

Covenant Violations
In your view, how serious are the violations? Legal counsel, with your input, drafts loan agreements that are tailored to each transaction and borrower. Loan agreements typically contain affirmative and negative covenants or standards that the borrower must satisfy to
continue to borrow. An effective loan agreement requires that timely and frequent financial statements be delivered. It generally includes covenants that permit you to monitor liquidity, leverage, and debt service coverage. They provide trigger points to protect the interests of the lender. Typically, covenants have three functions:

1. to allow you to gain control if the company's financial condition deteriorates
2. to ensure that a certain level of cash and other operating assets remains in the business
3. to maintain management stability in the business

Questions to ask include:

- Have you set up an effective system for monitoring the company's compliance with covenants? An early warning system is needed.
- Have you properly responded to covenant violations? When the borrower violates a covenant, you should provide notification in writing which should outline how you intend to deal with the breach. Options include demanding the loan, extending the time for compliance or suggesting an amendment to the covenant if it is appropriate. Never ignore the breach. How you respond could set a course of dealing with the company that could limit your options when subsequent violations occur.

Late Payments

Late payments on debt are among the more obvious warning signs. This is typically the last sign before major problems surface. If late payments occur, you can demand the loan, extend the time for payment or suggest an amendment to the payment terms. Never ignore the breach. How you respond could set a course of dealing with the company that could limit your options when future payments are late. Questions you might ask include the following:

- Did the company warn you in advance that the payments would be late?
- Did the company give a plausible explanation for the late payments?
- Was the cause a temporary problem that has no permanent implication?

Overadvances

Overadvances on a borrowing base are a primary cause of loan loss. Deviations from anticipated line utilization suggest potential problems. When an overadvance occurs, it overrides the lending decision you made in granting the loan. Questions you might ask to determine the reason for the overadvance include:

- Was it required to finance unanticipated growth of the business? If so, are you willing to finance that growth?
- Was the overadvance caused by slowdown in accounts receivable collection or other liquidity shortfalls?
- If accounts receivable collections are slowing, why? If so, are you willing to continue your financing arrangement?
- Did the borrower utilize the operating line of credit for purposes other than working capital, such as fixed asset acquisition?

Deteriorating Trends

This warning sign comes in many forms. Trends to consider include:
**Slowdown in Accounts Receivable Collection**
- Is it a function of credit policies and collection practices?
- What is the size of an average transaction?
- Can the company make money on a minimum credit transaction?
- How long does the company wait before beginning collection procedures?

**Increase in Fixed Assets with No Corresponding Increase in Sales**
- Did the company acquire the additional assets to prepare for anticipated future demand or to inflate the balance sheet? An increase in fixed assets accompanied by a corresponding increase in sales would generally be a positive sign for the company. If the company purchases more fixed assets and does not have sales growth, it may not be able to service its debts.
- What is the basis of the company’s predictions and are they reasonable?
- How were the fixed asset acquisitions financed?
- Are there purchase money security interests that would be senior to your collateral position?

**Fixed Assets Financed with Short-Term Debt**
- Is the company financing assets with consideration to sources of repayment?
- Is short-term debt financing the purchase of long-term fixed assets rather than short-term needs?

**Declining Sales**
- Did the loss of a major account cause the decline? If so, does the company have any prospects for replacing that account?
- Did a change in competition or new regulations cause the decline?
- Does the company have a workable plan to meet this new challenge?

**Rapid Increase in Sales**
- Is the company discounting prices to increase sales?
- Does the company have the capability to finance increased accounts receivable and/or inventory caused by the increase in sales?
- Has the company lowered its credit standards to spur sales? Is the company’s bad debt expense increasing?

**Increase in Sales with No Increase in Equity**
- Are profit margins being eroded? Rapid sales growth with consistent margins would be expected to result with commensurate increases in equity. When this does not occur, it may indicate that growth has been excessive.

**Slowdown in Inventory Turnover**
- Has the company failed to write off non-salable or obsolete inventory and book the loss?
- Has the loss occurred, but not yet been realized?
Operating Expenses as a Percentage of Sales are Increasing

- Have sales fallen?
- What effort has the company made to reduce operating expenses? Operating expenses tend to be fixed in nature. Therefore, when sales fall, the company must make an effort to reduce operating expenses to keep the percentage constant.

Dramatic Changes in the Relative Mix of Accounts Receivable and Inventory

- Are the changes unusual for this company, that is, not due to seasonality? The balance or relationship between accounts receivables and inventory (and cash, of course) is not static and often changes over time—especially in seasonal companies.
- Do you have a good understanding of the operating cycles of the company? You will need this understanding to be able to recognize when the balance or relationship changes in ways that were not expected.

Revaluation of Assets

- Are you over-lending based on an unrealistic appraisal? Companies revalue assets to create equity and increase borrowing capacity.
- Is your collateral actually worth the value claimed? Revaluation may not be allowed under generally accepted accounting principles (GAAP), but sometimes occurs in compiled statements in which the accountant reports management’s assessments without passing judgment.

Multiple Liens on the Same Bundle of Assets

- Do the liens indicate that suppliers are worried about getting paid?
- Are the liens old enough to avoid a bankruptcy preference claim? In a bankruptcy, unsecured suppliers who attempt to improve their positions, have a 30-day preference window. The presence of supplier purchase money security interest (PMSI) inventory liens often suggests serious problems exist.

A Widening Gap between Gross and Net Sales

- Are returns, allowances, and discounts causing a deterioration in the company’s gross profit margin?
- Does the level of returns indicate poor quality or dated goods?

Positive Cash Flow Derived From Nonoperating Sources

- When positive cash flow is being derived from nonoperating sources, such as sale of fixed assets, it provides evidence that the company’s business plan is not working. The company’s strategy may not be sustainable.

High Dividend Payouts

- To whom are the dividends being paid? Dividends do not always make economic sense for owners who also receive a salary from the company. Dividends are paid from after-tax profits, on which the company has paid taxes and the recipient will also pay taxes.
- Are the dividend payouts hindering the ability of the company to internally finance?
**Loans/Advances to Insiders**

- Are the loans or advances vulnerable to Canada Revenue Agency (CRA) attack? The CRA can recharacterize loans or advances to insiders as dividends or salaries. You need to look carefully at these transactions, noting the rates, terms, and repayment provisions.
- Are the “loans” having a negative impact on liquidity and working capital?

**Conversion of Short-Term Bank or Trade Debt to Long-Term Notes**

- Does the converted debt have a viable source of repayment? Conversion of short-term debt to long-term debt changes the source of repayment from conversion of assets to long-term profitability. Ensuring a viable source of repayment is critical in converting short-term debt to long-term.

**Tax Problems**

- Has the company paid its property taxes? Nonpayment of property taxes places a lien on property that is superior to your lien.
- Has the company submitted withholding taxes to CRA?

**Debt Service Deficiency**

- Does the company have sufficient cash flow to fund its operations and pay your loan? Are the owners/investors able and willing to provide additional capital equity?
- Does the company have assets it could sell?
NON-FINANCIAL CAUSES

Non-financial causes of company problems are not as easy to detect as financial ones but can be equally damaging. Non-financial causes may include the following:

- Deteriorating Supplier Relationships
- Management Issues
- Ownership Issues
- Industry Problems
- Economic Cycles

Deteriorating Supplier Relationships

The following may provide warning signs of deteriorating relationships between the company and its suppliers:

**Disproportionate Increases in Trade Debt and Accruals**

- Is the company making late payments or partial payments to suppliers?
- Have you received a rising level of inquiries from suppliers?
- Is there a buildup of accounts payable to suppliers? When this happens, suppliers may impose stricter terms, including the extreme “pay on delivery.” They may also require the company to convert trade debt to notes payable and may file purchase money security interest liens. Your lien position could be affected.

**Conversion of Trade Debt to Notes Payable**

- Is there an increase in notes payable and a reduction in accounts payable?
- Are the changes caused by a conversion of trade debt to notes payable? If so, the supplier or suppliers will likely file purchase money security interest liens. Your lien position could be affected.

**Violation of Franchise or Distributorship Agreements**

- Does the company have a franchise or distributorship arrangement with its supplier(s)?
- Has the company violated its agreement(s)?
- Can the violations be cured?
- What penalties are likely?

Management Issues

Management skills can be a primary cause of business failure. Inadequate management can cause or prevent resolution of problems (see the Management Risk Analysis discussion elsewhere in *Dimension 7*).

**Lack of a Supportable Business Plan and Forecast**

- Does the company have a business plan and forecast?
- Are the company’s business plan and forecast realistic? Do facts support them? The most common cause of problem loans is a lack of adequate management. Management should be able to articulate a defensible short and long-term strategy.
In what phase of development is the company? Is it an emerging, stable, mature or declining company? The greatest risk to the company and your financial institution comes in the emerging and declining phases (see Industry/Product Life Cycles in Dimension 1).

**Inability to Meet Scheduled Commitments**

- What is the nature of the commitments it has failed to meet?
- What has caused the failure? Has management failed to consider the company’s capital requirements?
- What has been the effect on customer relations? When management cannot meet production, delivery or other commitments on schedule, orders get canceled, goods get returned, penalties are assessed and payments are held back. The cause can be due to either overselling or poor planning.

**Return of Solved Problems**

- In solving problems, does the company attack the causes or only the symptoms?
- How soon after being “solved” do the same problems reappear? When previously solved problems reappear within a relatively brief period of time, it is likely that management cannot find an effective solution.
- What kind of help is available? Is there untapped management talent within the company? Could a financial consultant help?

**Capital Withdrawals/Dividend Payouts**

- Have the owners withdrawn capital or paid themselves significant salaries or dividends?
- Are the capital withdrawals, salaries and dividends depriving the company of needed capital? Growing businesses need capital in the form of owner’s equity and debt. Owners may expect you to finance their strategies while withdrawing excessive amounts of capital from the company. You can add covenants to loan agreements to require capital to be maintained at minimum levels and to require injection of new owner capital to meet shortfalls.

**Poor Financial Controls**

- Is the company’s financial information late or inaccurate?
- Does this indicate that the company has failed to establish effective internal controls and systems? This usually occurs when the owners or managers of the business have not contracted for quality auditing reports or good bookkeeping systems. The best way to avoid this problem is to examine the company’s procedures before making the loan. If you find them unacceptable, you can require changes as a condition to making the loan.

**Poorly Coordinated Interoffice/Intracompany Transactions**

- Is the company divided into a number of small departments?
- Does it have affiliates?
- Are there transactions between departments and affiliates? Is it possible to clearly track those transactions? If the company has a number of small departments or business entities, it is important to be able to track ownership interests in the business entities and transactions among them.

**Changes in Personal Habits of Owners/Management**

- Has an owner or manager changed his or her lifestyle?
• Has an owner or manager changed his or her personal investing style?
• Have you noticed unusual personal behavior by an owner or manager?
• Has an owner or manager become less willing to share information? You must be able to identify lifestyle changes that could distract owners/managers from running the business or cause them to divert business funds for personal use.

**Supporting Multiple Family Members at the Expense of Management Expertise or Profitability**

- Are there family members on the company payroll?
- Do they actually work for or provide services to the company?
- Do they add “value” equal to their compensation from the company? You should identify salary and other forms of compensation channeled to individuals who do not work for or provide services to the company.
- Should the money being spent on family members be redirected to the hiring of management expertise or funding of operations?

**Venturing Into New Business or Investment Areas Outside of Proven Areas of Expertise**

- Has the company diversified into new business areas?
- How closely do the new business activities relate to the company’s proven expertise?
- Does the owner or manager have any experience in the new line of business? When a company gets involved in new activities that depart from their existing business, attention gets diverted from the ongoing operation of the entity for which you have provided financing.
- Has the company diverted funds into unrelated investments?
- Has this left the company with insufficient operating funds?

**Managing Profitability**

- Is the company managing profitability for tax reduction or has it mismanaged expenses? Tax minimization is acceptable as long as it is not considered fraud. However, extensive tax minimization strategies that reduce profitability can effectively reduce the company's debt capacity.
- Are you able to get a clear view of the company’s financial performance and condition?

**Asset Management**

- Is the company maintaining the condition of its operating assets?
- Is the company properly servicing its equipment, updating its computer hardware, upgrading its software and protecting its business data? Well-maintained assets create the products or services that provide the cash flow to pay your loan as well as providing a secondary source of repayment.

**Ownership Issues**

**Unplanned and Unanticipated Changes**

- Has the company made changes in management or key personnel? (see Management Risk Analysis in Dimension 2)
• Has part or all of the company been sold to new owners?

• Do the new owners, managers or key personnel have the ability to implement the company’s strategy? Changes in management, ownership or key personnel can be a warning sign that a loan may become a problem. Your original analysis was based on the ability of current management to implement the company’s strategy. You will need to do new analysis to determine the effect of any changes.

**Succession Planning**

• Is the company dependent upon the expertise of the owner for success?

• Is someone ready to step in if the owner is absent, becomes sick or dies? Has the owner been unwilling to share authority or management responsibility?

• Is the owner stretched too thin to be effective?

• Is there anyone in the company who can challenge unwise decisions the owner may make? Succession planning requires a focus on both personal and business financial planning needs.

**Industry Problems**

Industry segments may experience declines, despite the overall health of the economy. Problems common to an industry may include (see Industry Risk Analysis in *Dimension 1*):

• Excessive regulation
  – Can the company comply?
  – What does it cost the company to comply?
  – Can the company recover the cost by increasing product prices?
  – Will increased prices cause declining sales?

• Product/service life cycle
  – Does the company sell a product or provide a service that will always be in demand?
  – Will technological or other changes make the product or service obsolete?

**Economic Cycles**

• Is the nation’s economy headed for a recessionary period?

• The economy is cyclical. When serious economic downturns occur, almost all loans become potential problems. You must take steps to determine what effect the downturn will have on your borrower’s business.

• Is the company’s business well positioned for an economic downturn?

• In a recessionary economy, consumers generally reduce spending for unnecessary items. Companies selling necessary items would likely survive. For instance, a company that makes spare parts for automobiles would be more likely to survive than a new car dealership. Consumers would put off buying new cars but need parts to keep their old cars running.

**Account Management**

There are four basic methods for dealing with a problem loan once it has been identified. They are as follows:
• **Workout specialist or special assets group.** In this case, the account manager is not included in the process. The advantage of this approach is that the specialist or group has the expertise and time to effectively manage the problem loan. Their view of the credit is not influenced by prior relationships. The disadvantage is that the specialist does not have the account manager’s extensive experience with the account nor the personal relationship with the client.

• **Shared responsibility.** In this case, the account manager works with the workout specialist to manage the relationship. The special assets group serves as consultant, providing assistance. The credit may move to special assets, but the account manager stays involved to provide the benefit of his or her experience and knowledge of the credit and the company.

• **Account manager.** In this case, the account manager stays with the account "no matter what" with no special assistance. This is the least desirable approach. It is unlikely that he or she has either the time or expertise to effectively deal with a problem loan in a workout or exit strategy.

• **Task force approach.** In this case, on any credit over a certain dollar level, a senior level task force is assigned to be the decision-making body. It provides a quick and efficient way to handle situations as they arise. This may be used in combination with any of the other methods.

Effective use of legal counsel is necessary in any event. The cost of legal counsel can be high. The key is to use counsel judiciously and selectivity. Use counsel for legal advice, and not for structuring the transaction.
Gathering Information

When a problem occurs, it is critical to understand the range and scope of the issue. Gather data about the company, the economy, the company’s position in the marketplace, and management. First, check your own credit files. Much of the information you need should be there, including:

- A description of the relationship between the account manager and the borrower. This can provide insight into the ability of the account manager to handle the workout and the likelihood that the borrower will cooperate.
- Whether the account manager recognized the developing problem and took effective early measures to deal with it.
- Financial statements or correspondence that may provide clues to the cause and nature of the problem. Correspondence may reveal a basic “people” or “communication” problem.
- Whether there is legal vulnerability or advantage. A review of documents may reveal deficiencies that can be corrected.
- Whether there are potential debtor defenses. The files can be subpoenaed. Do they include subjective comments that may indicate account manager bias or unfairness? Is there indication that the financial institution was controlling the borrower?
- Talk to others in the industry; speak with companies of similar size in the same economic environment and with the company’s customers and vendors. Talk to other financial professionals about firms that are in the same industry, that are the same size, or that operate in similar markets.

In this section, we will review the following elements of “gathering information:”

- Documentation Review
- Lien Searches and Evaluation of Collateral
- Financial Analysis
- Management and Operations
- Industry Positioning
- Financial Problems
- Survivability Analysis
- Risk Level/Classification
- Analytical Aids
- Special Concerns in the Analytical Process
DOCUMENTATION REVIEW

The first thing you should do at the sign of a problem is a complete documentation review. Typically 60% of files reviewed at the time they become problem loans have major documentation deficiencies. Your position is only as strong as the documents you have to support it. You must review the following types of documents:

Authority Documents

Authority documents include borrowing certificates or resolutions and incumbency certificates. These documents tell you who is legally qualified to borrow and under what circumstances. You also need to discover whether the documents cover all borrowing or grant limited authority (see Borrowing Entities Authority and Execution in Dimension 6).

Notes

- You need to determine who signed the notes and whether they were authorized to do so.
- Have the notes matured?
- Have overadvances been made?
- Do they include a clearly stated interest rate and repayment schedule?
- Is there an upset interest rate? That is, does the rate automatically increase if the borrower is in default?

Security Agreements and Financing Statements

Two kinds of key documents involved are security agreements and financing statements. Security agreements are used to grant security interests in assets. Financing statements are filed to perfect those security interests.

- Did the proper person(s) sign the security agreements?
- Have the financing statements been filed in the correct locations?
- Are the financing statements still valid?
- Do the security agreements and the financing statements correctly name the debtor using the actual name of the debtor and not a trade name?
- Do they adequately describe the collateral, either specifically or by type?
- If the collateral includes accounts, do you have current lists of your borrower's customers?

Mortgages

If the documents include mortgages, did the proper person(s) sign them? (See Security Documents, Mortgages in Dimension 6)

- Were they correctly recorded in the proper office(s)?
- Is there a title report or policy?
- Is the legal description clear and consistent among all of the documents?
Assignments (Leases/Rents); Landlord Waivers

- Are the assignments general or specific?
- Is there a landlord waiver?
- There should be a landlord waiver in the file if your collateral is equipment affixed to real property or is equipment or inventory located on leased premises. Without a landlord waiver you may not be able to get physical possession of the property.

Entity Verification

- You must confirm the exact form of the borrower’s name with Jurisdictional or local offices in which the borrower was required to register to establish its existence.
- Is the borrower’s name consistently used in all documents? (see Borrowing Entities, Authority, and Execution in Dimension 6)
- Are all of your documents dated later than the date of the registration? If not, they may not be enforceable against the borrower.

Guarantees

- What type of guarantee is involved?
- Is it a guarantee of payment or collection? Most banks’ forms of guarantee are guarantees of payment. With a guarantee of payment the guarantor pays the full amount of debt on demand. With a guarantee of collection you may be able to require the guarantor to pay, but you must exercise all remedies against the borrower first. Most standard bank forms are guarantees of payment.
- What is the amount of the guarantee?
- Is it limited or unlimited?
- Was the guarantor provided advice as to the significance of the guarantee (for example, under the Guarantee Acknowledgement Act in the Province of Alberta)?
- If the guarantor is not directly involved in the business, do you have proof that the guarantor has been notified of significant changes in the borrowing relationship? If not, the guarantee could be subject to challenge. The reference to “directly involved in the business” refers to someone who is party to the ongoing business transactions, for example, the President or primary shareholder, who conducts the day to day operations. You should not assume that “involvement in the business” at a lesser capacity is sufficient not to notify of changes in the borrowing relationship.

Loan Agreements

- Is there a loan agreement? If not, your ability to act will be severely limited.
- What provisions are in the agreement? (see Content of Loan Agreements in Dimension 6)
- Have you previously waived breaches? If a violation or breach has been ignored, it could be considered a waiver. The waiver could be used to challenge the entire agreement and make it less enforceable.
- What notice provisions are included in the agreement? You will need to make certain that proper notices are given before you take action.
LIEN SEARCHES AND EVALUATION OF COLLATERAL

Determination of Lien Priorities
You must order lien searches and obtain copies of all filings to determine whether you have senior liens on collateral. Searches must be ordered from all locations in all Jurisdictions where financing statement filings were required at the time the loan was made. Where possible you should order Department of Motor Vehicle searches to determine all of borrower's vehicles licensed in the Jurisdiction. This search may reveal unencumbered assets that can be used as part of a workout plan. Privacy laws in some states make motor vehicle lien information difficult to obtain.

Status of Taxes
Does the company have delinquent tax obligations? You must investigate all Jurisdictional sources. If tax liens exist, they may have priority over your perfected liens.

Status of Lawsuits or Judgments
Money judgments can trigger a defensive bankruptcy, which means that your borrower may file a petition in bankruptcy to prevent seizure of assets by judgment lien holders. If lawsuits are pending or judgments have been handed down, you must factor the risks into your workout plan. You should ask your legal counsel for an assessment of the risks involved.

Quantitative and Qualitative Analysis of Collateral
- Start a collateral audit as soon as possible.
- Obtain current accounts receivable agings and equipment lists.
- Conduct an inventory audit.
- Obtain current third party valuations and appraisals, where needed, to confirm asset value. Expert opinions are more costly, but add value in the event court action becomes necessary.
- Do a “going concern” value analysis to determine the value of assets if sold as part of an ongoing business.
- Do a liquidation value analysis to determine the value of assets if disposed of in a liquidation sale.

FINANCIAL ANALYSIS
Obtain and review the following:
- Updated accrual basis financial statements and projections prepared by an independent accountant. Only an independent accountant has an entire view of the company and no bias toward management. The accountant has a professional duty to be accurate and complete.
- Inventory valuation analysis. First in First out (FIFO) vs. Last in First out (LIFO). The use of LIFO tends to increase the cost of goods sold in a period of inflation. It may mean that the company’s profits are understated. Canadian tax laws require FIFO be utilized for tax purposes, and therefore most accounting records are done on this basis. If you are unsure, refer to the company’s tax returns.
- Pro forma cash budget and profit plan for the next 12 months. It must include accrual profit and loss numbers, a month-to-month rolling budget and an analysis of borrowing needs. The ability to preserve and generate cash is the key to the company’s survival in the short term.
The cash budget details the sources and uses of cash and the resulting excess or shortage for each period.

- Capital budget. This schedule of proposed capital expenditures helps identify prospects for cutbacks, deferrals or elimination. These are opportunities to reduce cash outflow.
- Breakdown of obligations owed to you by owners of the business, guarantors and affiliates of owners and guarantors.
- Tax returns for the business entity and guarantors. The returns reveal important information including dividend interest income, debts, assets and partnerships.
- Updated personal financial statements (compare to previous years)
- Debtor’s examination. A debtor's examination is a nonjudicial procedure in which the borrower submits to a deposition-like questioning under oath in the presence of the registrar of the court (or other authorized person). When used selectively, it can be valuable in revealing assets that you can encumber as part of a workout.
- Depreciation schedules. Look for unencumbered assets.
- Records of debt owed by borrower, owners, guarantors and affiliates to your financial institution and to other creditors. It is important to cover all areas were money can "exit."

Inform all administrative and customer contact personnel (including those who answer the phones) of the changed circumstances. Legally they are presumed to know all that you know. You must make certain they do. If not, they may make inaccurate responses to credit inquiries and expose your bank to liability.

**MANAGEMENT AND OPERATIONS**

Review management strategy and operations, including:

**General Management Capacity (see Management Risk Analysis in Dimension 2)**

- How well defined is the company’s organizational structure? Is there a clear chain of command? Are job responsibilities clearly defined?
- What is the forum for policy setting and major decisions? Which managers participate?
- Can the company define its business and outline its goals and objectives? What is the quality of the company’s forecasting and planning?
- Can management define key items that must be controlled? Are there systems in place to monitor them?
- Are management reports of reasonable quality, thoroughness, scope and frequency?
- Does the company have adequate accounting systems? The Auditor’s management letter should be reviewed. This documents material operational issues found deficient within the company’s financial control systems that could represent considerable risk. You should also obtain a copy of the company’s response.
- Does the company have an effective inventory management system?
- What is the quality of the company’s inventory as it relates to regulations and codes, state-of-the-art technology, taste, style, and cost (inclusive of operating expenses)?
- Does the company have financial standards and goals for such things as financial leverage, profitability, cash flow and growth?
- Are monthly cash and credit needs understood and projected with accuracy?
• Can the company generate reliable cost data?
• What is the company’s marketing strategy? Is there a detailed plan to support it, which includes advertising, pricing and distribution?
• How often is a market and competitive assessment made? How does the company determine customer preferences and satisfaction?

Crisis Management Capacity
• Has the company previously faced crisis situations? If so, was current management in place at that time? How did they handle the crisis?
• If inexperienced, does current management have the capacity to deal with crisis?
• What is management’s assessment of the situation? Is it realistic, overly optimistic or too pessimistic?
• Has management developed a plan to deal with the problem? Is it sufficiently specific with objectives, responsibilities, timetables and costs outlined?
• Has management sought outside or professional advice?
• How committed is management to the plan?

Management Controls

Accounts Receivable
• How are credit checks performed on customers and potential customers? What sources are used? How often?
• Are credit limits and terms established for individual customers? Who sets them? What guidelines are followed?
• Who has final approval on a sale—the salesman, manager or credit person?
• Can the company readily produce an accounts receivable aging?
• What percentage of receivables is past due? What past-due percentages are considered acceptable?
• What procedures are followed to collect past dues? Who collects them? When are they turned over to a collection agency?
• What is the company’s charge-off policy? What has the company’s loss experience been?

Inventory/Purchasing
• What are the company’s purchasing procedures? How are purchase orders originated and approved? Who has final authority?
• On what basis are suppliers selected? How are they screened for quality and dependability?
• Are there major suppliers that provide more than 15%-20% of the company’s product? What is known of the suppliers’ financial condition and management?
• Is the company using perpetual or periodic inventory methods? Is inventory computerized with automatic reorder levels?
• How often are physical inventory counts taken?
• How often and on what basis are inventory write-downs made? What has past experience been?
INDUSTRY POSITIONING

The company’s performance should be measured against competitors and peers in the industry. The industry should be analyzed to determine its basic characteristics and expectations for turnaround (see Industry Risk Analysis in Dimension 1). For example, if the industry has matured, growth will have stagnated, competition will be severe and the strongest and best-managed will survive without major realignments. Factors to review include:

competitors

• How many competitors does the company have?
• How easy would it be for other competitors to enter the market, thus increasing competitive pressures?
• What is most important - price, quality or other factors - in determining the company's market share?
• What is the company's perceived position within the industry and the community?

market share breakdown

• What is the company's market share?
• Is the trend up or down?

customer base

• Is there a sales concentration in a few large customers or is there a broad customer base?
• What is the general financial and business condition of the customers?
• Is there a trend in the customer base?
• What are the prospects for obtaining new customers? Are the prospects based on an objective analysis? Management projections can be subjective and not always useful in evaluating a project's viability.

industry sales trends

• How do the company's sales trends relate to industry sales trends?
• Can industry sales problems be solved?
• Can the company outperform the industry by taking a bigger market share?

financial problems

questions to answer

You should consider the following issues in your analysis:

• What are the amount and timing of withdrawals and salaries paid to owners of the business?
• Are there excess non-earning assets? What are they worth? Are they salable?
• What is the cost of retaining existing leases? Are they needed? Can they legally be terminated?
• Are there long-term contracts? Are they needed? Can they legally be terminated?
• Are there held cheques and book overdrafts? What is the amount of exposure?
• What do you expect the company’s cash needs to be over the next 90 days?
• Does the company have the ability to reduce its general and administrative expenses? By how much and for how long?
• What is the level of the company’s current accounts receivable and accounts payable? Are aging lists up to date?
• What is the status of current rent rolls?
• What will the impact be on a break-even analysis if some of the lower margin products or services are eliminated?
• Will the company lose more money by continuing to operate or by shutting down? If in bankruptcy, will your claims be fully secured? Is there the potential of successful challenges to your claims? (see Bankruptcy Considerations elsewhere in Dimension 7)
• Is there a surplus or deficiency in the borrowing base?
• Are there outside sources of risk capital? How much is available? How soon can it be obtained?
• Is there a debt-service deficiency? Would restructuring enable the borrower to service its debt? If other creditors are involved, would it be possible to enter into an intercreditor agreement with them?

Calculating a Debt-Service Deficiency

Calculating A Debt-Service Deficiency

<table>
<thead>
<tr>
<th>Needs</th>
<th>Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Operational (Bank)</td>
<td>Margined Accounts Receivable</td>
</tr>
<tr>
<td>Debt</td>
<td>Borrowing Base</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>Margined Inventory Borrowing Base</td>
</tr>
<tr>
<td>Accruals</td>
<td>Equity Capital</td>
</tr>
<tr>
<td>Term Debt Payments</td>
<td>Extended Trade Creditor Terms</td>
</tr>
<tr>
<td>Overdrafts or &quot;Held&quot; Cheques</td>
<td>Asset Sales</td>
</tr>
</tbody>
</table>

Asset Acquisition Needs

To complete the calculation, you should subtract the sum of the items listed under Sources from the sum of the items listed under Needs. If the result is a positive number, a debt service deficiency exists.
Examples:

**Company A**

<table>
<thead>
<tr>
<th>Needs</th>
<th>Amount</th>
<th>Sources</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Operational Bank Debt</td>
<td>85,000</td>
<td>Margined Accounts Receivable Borrowing Base</td>
<td>160,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>230,000</td>
<td>Margined Inventory Borrowing Base</td>
<td>200,000</td>
</tr>
<tr>
<td>Accruals</td>
<td>0</td>
<td>Equity Capital</td>
<td>150,000</td>
</tr>
<tr>
<td>Term Loan Payments</td>
<td>55,000</td>
<td>Extended Trade Creditor Terms</td>
<td>45,000</td>
</tr>
<tr>
<td>Overdrafts or &quot;Held&quot; Cheques</td>
<td>0</td>
<td>Asset Sales</td>
<td>0</td>
</tr>
<tr>
<td>Total Acquisition Needs</td>
<td>80,000</td>
<td>Total Sources</td>
<td></td>
</tr>
<tr>
<td>Total Needs</td>
<td>450,000</td>
<td>Total Sources</td>
<td>555,000</td>
</tr>
</tbody>
</table>

Total Needs of $450,000 – Total Sources of $555,000 = ($105,000)

Company A does not have a debt service deficiency.

**Company B**

<table>
<thead>
<tr>
<th>Needs</th>
<th>Amount</th>
<th>Sources</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Operational Bank Debt</td>
<td>185,000</td>
<td>Margined Accounts Receivable Borrowing Base</td>
<td>160,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>230,000</td>
<td>Margined Inventory Borrowing Base</td>
<td>200,000</td>
</tr>
<tr>
<td>Accruals</td>
<td>25,000</td>
<td>Equity Capital</td>
<td>50,000</td>
</tr>
<tr>
<td>Term Loan Payments</td>
<td>55,000</td>
<td>Extended Trade Creditor Terms</td>
<td>45,000</td>
</tr>
<tr>
<td>Overdrafts or &quot;Held&quot; Cheques</td>
<td>0</td>
<td>Asset Sales</td>
<td>0</td>
</tr>
<tr>
<td>Total Acquisition Needs</td>
<td>80,000</td>
<td>Total Sources</td>
<td></td>
</tr>
<tr>
<td>Total Needs</td>
<td>575,000</td>
<td>Total Sources</td>
<td>455,000</td>
</tr>
</tbody>
</table>

Total Needs of $575,000 – Total Sources of $455,000 = $120,000

Company B has a debt service deficiency.

**Survivability Analysis**

Key questions to ask about the company include:

- Can the borrower survive? If not, there’s no need to proceed further with a workout. You should adopt an exit strategy.
- What resources are necessary to survival?
- Where will the money come from?
  - From the owners?
  - From third parties, such as, investors, guarantors or governmental agencies?
  - From you? If so, how much risk capital are you willing to provide?

**Risk Level/Classification**

When a warning sign(s) appear you should conduct a complete credit analysis. Use the procedures and tools you would normally use to risk rate credits. This will determine whether the
loan should be classified and may indicate that further steps are needed to deal with perceived problems.

You should rely upon an independent accountant as the best source of information to verify the accuracy and reasonableness of information about the company provided to you by management.

**Analytical Aids**

The following are helpful tools for analysis:

- **On-site analysis.** Evaluate the facility, management and quality of inventory. You cannot properly evaluate a project by telephone or from pictures in an appraisal.
- **Industry or peer group analysis.** Tools include RMA’s Annual Statement Studies and your credit files. It is important to compare a company's performance with both a successful and a "classified" account.
- **Turnaround or management consultants.** This can be costly. There are lender liability risks if you select the management consultant for the company. You could, however, hire an examiner to analyze your financial institution’s risk.
- **Break-even analysis.** What is the company’s sustainable growth rate? At what rate can the company increase sales with no change in equity or operating debt? This is a simple and fast method to identify areas in which the company can create cash flow.
- **Performance or trend line analysis.** The slope and mass of a variable determine the company's ability to reverse trends. Has there been a large percentage drop in unit sales and sales dollars? Has the change been gradual or occurring over a short period of time?
- **Computer modeling.** How reasonable are the company's projections given actual historical performance?

**Break Even Analysis**

**Step 1.** Classify costs as fixed or variable.

**Step 2.** Determine variable costs (VC) as a percentage of sales.

**Step 3.** Determine contribution margin ratio (CMR).

\[
CMR = 100\% - \text{Variable Costs}
\]

**Step 4.** Calculate break-even sales.

\[
\frac{\text{Fixed Costs}}{CMR} = \frac{\text{Break-Even Sales \$}}{CMR}
\]

\[
\frac{\text{Fixed Costs}}{(\text{Price Per Unit}) - (\text{Variable Costs Per Unit})} = \text{Break-Even Units}
\]

As discussed in Dimension 3, in order to determine the break even units required for operation of the company as well as repayment of debt, the debt servicing requirements should be included as a fixed cost.

**Example:**

**Step 1.** Total Costs of $3,000,000 classified as $970,000 Fixed Cost (FC) and $2,030,000 Variable Cost (VC).
Step 2.  Sales = $2,900,000.  $2,030,000 (VC) divided by $2,900,000 (Sales) = .70

Step 3.  Contribution Margin Rate (CMR) 100% - 70% (VC) = 30%

Step 4.  $970,000 (FC) divided by 30% (CMR) = $3,233,333 (Break-Even Sales $)

12,000 (P/Unit) - $9,000 (VC/Unit) = $3,000

$970,000 (FC) divided by $3,000 = 323 (Break-Even Units)

Break Even Matrix

<table>
<thead>
<tr>
<th>Units</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Break-Even Level</td>
<td>Fixed Costs</td>
</tr>
<tr>
<td>(P/Unit) – (VC/Unit)</td>
<td>CMR</td>
</tr>
<tr>
<td>Sales Level to Make a Profit</td>
<td>Fixed Costs &amp; Profit</td>
</tr>
<tr>
<td>(P/Unit) – (VC/Unit)</td>
<td>CMR</td>
</tr>
</tbody>
</table>

Example:

**Break-Even Level.**
$970,000 (Fixed Costs) divided by $3,000 ((P/Unit) – (VC/Unit)) = 323 Units.

$970,000 (Fixed Costs) divided by .30 (CMR) = $3,233,333 Sales Level.

**Sales Level to Make a Profit.**
$970,000 (Fixed Costs) + $50,000 (Profit) = $1,020,000 (Fixed Cost & Profit)

$1,020,000 (Fixed Cost & Profit) divided by $3,000 ((P/Unit) – (VC/Unit)) = 340 Units.

$1,020,000 (Fixed Cost & Profit) divided by .30 (CMR) = 3,400,000 Sales Level

**SPECIAL CONCERNS IN THE ANALYTICAL PROCESS**

The following are special concerns that may arise as you conduct your analysis:

**Documentation flaws**
- How serious are they?
- Can they be cured?
- At what cost?

**Historical relationship**
- What is the customer's history with your financial institution?
- Is there anything in your "course of dealing" that could expose you to lender liability claims?

**Method of dealing with the customer**
- Have you treated the customer professionally and responsibly?
- Do you have documentation to show that your actions are not arbitrary, capricious, or arrogant in dealing with the problem credit?
Other creditors
- What is the attitude of each?
- Is there any willingness to share the risk?

Ability to improve your collateral position
- Are there unencumbered assets?
- Can you obtain additional collateral without being unfair to third parties?

Ability to downsize
- Can the borrower sell off non-earning assets to reduce debt or operating expenses?
- Can the borrower make staff reductions?

Sources of risk capital
- Where can the company obtain money to fund ongoing operations during a turnaround attempt?
- Are the owners willing to inject new capital?
- Are there non-recourse transactions, that is, transactions into which the company has entered that can be avoided without recourse?

Loss analysis
- Is the risk of loss from continuing in the credit greater or less than the probable loss in liquidation or bankruptcy?
- Is costly litigation likely?

Legal issues
- If collateral includes real estate, are there environmental issues? (see Environmental Risk Analysis later in Dimension 7)
- Is a bankruptcy filing likely?
- Are there potential lender liability claims? Explore the ability to obtain a waiver or release as part of a workout agreement.

Developing Problem Loan Strategies
After you have identified a problem, you must develop a strategy. Costs will be involved. They will include:

- **Legal expense.** Don’t accept poor quality legal advice in order to save money. You should request an initial fee estimate and updated estimates as the case progresses.

- **Administrative expense.** Administrative costs make it impossible to achieve an acceptable return on a problem loan.

- **Reputation.** The cost of a damaged reputation may be one of the highest costs associated with problem loans. Excessive loan problems can cause damage to a financial institution’s reputation in the eyes of its existing and potential customers, providers of funds, and the investment and financial community.
• **Personnel expense.** A bank that is encountering extensive loan problems frequently loses its best people. They may see their long-term career prospects jeopardized by association with a "problem" financial institution.

• **Borrowing expense.** When a financial institution is perceived as having an excessive number of problem loans, the marketplace will charge the institution more for funds.

• **Lost opportunity.** Opportunities for normal growth and expansion are limited for the organization that finds itself struggling with excessive loan problems. Some financial institutions find the costs so steep that their very existence is threatened.

You have two choices. You can either choose a workout solution with a goal to improve the credit, or an exit strategy to move the credit out of your financial institution.

**WORKOUT RESOLUTION - SAVING THE CREDIT**

A workout resolution is the most probable option. When warning signs are recognized early enough, it may be possible to save the credit and limit your loss.

**Gaining Control over Your Exposure**

Gain control over your exposure by doing the following:

- Manage the loan to the collateral level.
- Re-size your line of credit availability to an amount that is appropriate to your earlier financial analysis findings. Apply line limitations and restrictions, such as limiting or eliminating advances against inventory, to help ensure your exposure is covered by the most liquid collateral possible.
- Shore up all deficiencies including loan documentation, loan structure and advance rates early in the process.
- If you do not currently apply advance rates, engage the help of a qualified field examiner to determine eligible collateral and to recommend appropriate advance rates.
- Consider a cash collateral account and lockbox together with a borrowing base certificate requirement to manage the loan-to-value position.
- If the borrower is undercollateralized, add collateral or design a plan that allows the borrower to phase back into compliance with an acceptable loan-to-value position.
- Have your legal counsel draft a comprehensive loan workout agreement.

**Adding Collateral**

If you identified unencumbered assets during your review, you could require the borrower to grant security interests or mortgage interests in those assets to secure the loan. When you take additional collateral you need to be aware of two issues:

- You must be able to prove that you gave “value” for the new collateral. If no new funds are being advanced you need to be able to prove you waived an event of default, extended the time for payment or otherwise gave up some right.
- Even if you can prove you gave “value,” the new collateral can be lost if the borrower either files a petition in bankruptcy or has one filed against it within 90 days after you obtain the new collateral. The 90 days is the bankruptcy preference period and applies to transfers of assets (new collateral) to secure an already existing debt. If the lender is deemed a related persons, the period would become one year rather than 90 days.
Guarantees
You could obtain guarantees to bolster a troubled credit. You need to determine whether the guarantees add strength to the credit and are enforceable. A guarantee is not enforceable unless it is supported by present or future consideration. In this situation, you would be taking guarantees in connection with a loan that already exists. You would have to prove that you had loaned more money, waived an event of default, extended the time for payment or otherwise given up some right in exchange for and reliance on the guarantees. Even if you could prove you gave present or future consideration, a new guaranty could be lost if the guarantor either filed a petition in bankruptcy or had one filed against it within 90 days after you obtained the new guaranty. The 90 days is the bankruptcy preference period and applies to transfers of assets (new collateral) to secure an already existing debt. If the lender is deemed a “related party, the period would become one year rather than 90 days.

If you have a Canada Small Business Financing Loan guarantee, you must notify them of the problem loan and obtain their consent to workout and/or liquidation plans as required in their rules and regulations.

Other Support
Third party security interests and subordinations are additional types of support that could be obtained to bolster a troubled credit:

- A third party security interest is a collateral interest obtained from a party other than the borrower or a guarantor (see Third Party Support, Collateral Agreements, and Collecting from a Third Party Security Interest Grantor in Event of Default in Dimension 6).
- A subordination agreement could cover either debt or a collateral position. The subordinating creditor agrees to take a junior position to your institution as to repayment of debt or distribution of proceeds from collateral sales. Bankruptcy courts generally honor subordination agreements. However, the subordination can be lost if the subordinating creditor either files a petition in bankruptcy or has one filed against it within 90 days after you obtain the subordination. The 90 days is the bankruptcy preference period and applies to transfers of assets (subordinations) in connection with an existing debt. If the lender is deemed a “related persons”, the period would become one year rather than 90 days.

Business Plan
If you want to save the relationship rather than exit, you should require the company to establish a realistic business plan. This is the most likely strategy to assist the company in returning to profitability.

Financial Consultant
If the borrower cannot establish a realistic business plan to improve performance, an outside consultant or turnaround specialist may be able to help management revive the company. This can be especially effective if your analysis has shown that many of the company’s problems are related to management and operational issues. You cannot require that the company hire a consultant named by you, as this would expose you to a lender liability risk.

EXIT STRATEGY
We will now discuss various options and procedures for exiting the credit.
Outplacement as an Option

Once you decide on outplacement, there’s usually no going back. Irreparable damage can be done to the relationship. Changing your mind could involve course-of-dealing and waiver issues that could be raised in lender liability actions.

Key Questions to Ask

- Do you want this borrower?
- Has the borrower done something that has reduced your confidence in them? For instance, did the borrower sell collateral without telling you and not use proceeds to pay down the loan?
- Will your financial institution’s reputation suffer from outplacement? Do you want to be known as the lender that moves customers out?
- What are the consequences of outplacement for you? The risk of loss from continuing in the credit may be less than the risk of loss in bankruptcy or litigation.
- What will be the cost to your financial institution if the loan becomes a non-performing asset?
- What will be the cost of managing the credit?
- What will be the costs in litigation?
- What is the cost of lost opportunity?

Issues to Consider

- Can the borrower refinance with another financial institution? The ability to transfer marginal credits varies from market to market, depending on how aggressively lenders are seeking new business.
- What is your history with the borrower?
- Is the borrower’s current condition worse than it has been in the past?
- Have you routinely waived defaults in the past? If so, why are you changing your attitude toward borrower’s defaults?
- What is management’s ability to adapt in a crisis? You should grant extensions if the borrower is making substantial progress toward obtaining takeout financing, has a firm purchase commitment for sale of an asset that will result in reduction of your debt or is providing other forms of consideration sufficient to warrant a reasonable extension period.
- Are economic factors part of the company’s problem? Are they likely to get worse or are they likely to improve?
- Is the industry (service/product) in which the company is engaged viable? (see Industry Risk Analysis in Dimension 1)

Effectively Communicating the Decision

You should communicate your decision to the borrower in a face-to-face meeting and confirm the decision in writing. Provide the letter to the borrower at or immediately after the meeting.
Provide Adequate Notice

Loan agreements typically require notice periods of 10-15 days for normal defaults. Adequate notice of a decision to exit a credit is usually 90-120 days, unless the project is very complex or your past course of dealing with the borrower has included longer notice periods. Obtain and keep evidence of delivery of notice.

Content of Notice

- Be simple and direct. Avoid citing specific reasons, otherwise the borrower may attempt to invalidate them. Address the following:
  - You will not honor overdrafts.
  - You will make no payment of cheques against uncollected funds.
  - Outline the conditions under which you may be willing to make advances.
  - Provide a copy of the letter to all guarantors. Have the borrower and each guarantor sign a copy and return it to you.

Another Lender

There are lenders that have a higher tolerance for credit risk who may be willing to assume the debt. You may be able to sell your loan at a discount. If you have done an effective review of the problem loan, the discount you give today will most likely be less than the loss you could suffer in foreclosure, litigation or bankruptcy. If you decide to sell the loan, you must fully disclose to the buyer all that you know about the relationship. For instance, if you have a customer that has rapid growth but limited capital, causing over-advances on its line of credit, the best strategy could be to move the loan to an asset-based lender.

Liquidation

This option is only suggested when there is a high probability that this is your only source of repayment. You can expect a charge-off and the business and its entrepreneurs will lose their entire investment.

Call On Guarantor

Most guarantors never expect to be called upon to pay. In many cases guarantors look for ways to avoid having to pay. Many Jurisdictions provide guarantors with legal defenses that make collection difficult. Your position will be strengthened if you have obtained and kept evidence that the guarantor understood the terms of the loan that was guaranteed, such as that required under The Guarantees Acknowledgement Act in Alberta. This is somewhat easier if the guarantor is someone directly involved in the business, more difficult if the guarantor is not involved. If you have obtained written consent from guarantors to subsequent changes in the loan, you will have a better chance of enforcing your guarantees.

Bankruptcy Considerations

When financial burdens become too difficult, many borrowers and guarantors seek protection in bankruptcy court. When this happens you should immediately inform your legal counsel and turn the matter over to an attorney. Two bankruptcy considerations will immediately affect you and your relationship with the filer:

- You will need to determine whether you have benefited from a preference.
- You will also have to know and follow the automatic stay rules.
**PREFERENCE PERIOD**

The trustee in bankruptcy has the power to void some transfers of a debtor’s property made within certain time frames prior to the bankruptcy petition filing. Both voluntary and involuntary transfers are included. Payments made by the debtor to the lender could be reversed. The trustee could also recover property seized by you prior to the filing. An avoidable preference is a transfer of an insolvent debtor’s money or other property to a creditor as payment on a debt, which gave that creditor a greater percentage of repayment. Besides payment of money and seizure of property, voidable transfers include grants of security interests, perfection of unperfected liens and attachments of involuntary liens. The preference periods are:

- **90 days for non-related persons.** The trustee would have the ability to reverse only those transfers that occurred within the 90 days prior to the petition filing. You would be allowed to retain regularly scheduled loan payments made during that time.

- **One year for related persons.** The trustee would have the ability to reverse only those transfers that occurred within the one year prior to the petition filing. As the term implies, related persons are parties who are not dealing “arm’s length” with the debtor. Examples of related parties are individuals operating the debtor’s business, or a spouse or relative. “Related persons” is further defined under Section 4(2) of the BIA. A creditor could also be categorized as a related party for preference purposes. This would happen if the bankruptcy court found that the creditor had become involved in the day-to-day operations of the debtor’s business. This would be deemed excessive control. The courts determine who will be considered to be a related party.

**AUTOMATIC STAY**

An automatic stay comes into place immediately when a petition in bankruptcy is filed or a CCAA filing is made. At that point, all actions to collect a loan are prohibited. You may not legally:

- Commence or continue any judicial, administrative, or legal process against the debtor.
- Enforce a judgment against the debtor or its property obtained prior to the filing.
- Obtain possession or exercise control over the property of the borrower.
- Create, perfect or enforce any lien against the property.
- Collect, assess or recover a claim against the debtor that existed before the filing.
- The automatic stay does not stop any action taken against a guarantor to recover a claim that arose before the filing.

**Lender Liability**

When a financial institution sues to collect a debt, it is often faced with a borrower counterclaim that the institution be found liable for some action it took or failed to take. These counterclaims are called lender liability claims. The following are among the theories put forth in such claims:

- Failure to Negotiate in Good Faith
- Interference/Control Risk
- Failing or Refusing to Lend
- Improper Acceleration or Foreclosure
- Exchange of Credit Information
- Breach of Fiduciary Duty
FAILURE TO NEGOTIATE IN GOOD FAITH

Many lenders send letters to customers representing that they would lend certain amounts at a certain rate for a certain period of time (basically a commitment letter) subject to certain factors. These factors could include:

- Financial statements and other information to be provided by management.
- Collateral requirements.
- Appraisals.
- Proof of corporate existence.
- Negotiated terms in the loan agreements.

The lender feels protected from a final commitment by language that typically states that the loan “will be at the lender’s sole discretion” or the loan will be “contingent upon the lender’s satisfaction with the company’s response and the execution of acceptable documents.”

Commitment Letter Risk

The problem with commitment letters is that, in a dispute, a court must judge (frequently in the absence of any further information) whether your decision not to fund a loan was based on evidence that is clear.

For example, courts have found that when a borrower refused to execute the lender’s loan documents, it was because they contained clauses that were not included in the commitment letter and that the lender should have known would be unacceptable to the borrower. Even though the commitment letter included such a statement, as “borrower will execute documents in a form acceptable to the lender,” the court could decide that the lender did not negotiate the additional terms in good faith. Unacceptable terms include standard clauses such as waiver of jury trials, confessions of judgment, and exclusive jurisdiction.

Protecting the Financial Institution

You can protect your financial institution in several ways. If you don’t intend to commit, don’t send a commitment letter. If you send a commitment letter, have it drafted or reviewed by your legal counsel and include as many of the loan documents, including clear definitions of terms and conditions, as are available.

Comments

Disputes over what was said between the two parties can cause lender liability suits to occur. Whenever you meet with the borrower, have another representative of your financial institution with you and document what transpired for the credit file.

INTERFERENCE/CONTROL RISK

This risk arises when you interfere with or control a borrower’s business to the extent that you dominate the borrower and misuse that control for your own purpose, i.e. repayment of your loan. A court may hold you liable for any damages that result to the borrower or any third parties.

Protecting the Financial Institution

To avoid interference/control risk, do not:
- Attend or solicit others to attend the borrower’s board meeting on your behalf.
- Serve or have another employee of your financial institution serve on the borrower’s board.
- Exert or appear to exert pressure on the borrower’s board.
- Involve yourself in the selection of the company’s management or a consultant to management.
- Involve yourself in the direction or development of the firm’s strategic or tactical plans.
- Make suggestions to management as to which of the firm’s cheques should be honored or returned.

**Failing or Refusing to Lend**

Many lenders provide discretionary lines of credit to borrowers with a demand note evidencing an obligation to repay advances. Under these credit facilities, the lender reserves the right, at its sole discretion, to refuse to make any advances. The lender is not required to have a reason for the refusal to lend. When it refuses to lend, however, the borrower may claim that the lender did not act in good faith.

**Failing-or-Refusing-to-Lend Risk**

Typically, problems with discretionary line of credit agreements are few if everyone understands the contract. Lenders get into trouble when they make statements to the borrower that go beyond the written documents. For example, indicating, “Although the documents state that the line a demand loan and we can request repayment at any time, all things being equal, we would not expect to demand your loans” exposes the lender to possible future litigation.
Protecting the Financial Institution

To avoid failing-or-refusing-to-lend risk:

Have all agreements and amendments relating to the loan and security in writing and signed by all parties.

• Keep a written record of all the borrower’s defaults and related conversations. Limit credit file comments to factual matters. In litigation, all written materials are subject to discovery.

• For committed loans, provide the borrower with written notification of an event of default. Include any actions you plan to take. No default is required in order to request repayment of a demand loan.

• If you are waiving an event of default in a committed loan, indicate that you are waiving this event only, and that any other default, whether the same or some other, will be dealt with as it occurs.

• Consult with senior management and/or your legal counsel, before refusing to fund or calling a loan.

• Notify the borrower, in writing, if you are contemplating demanding a loan or intend to make a substantive change in the way you deal with the borrower. Your prior course of dealing with the borrower may limit your ability to make changes. Allow time for the borrower to seek alternative arrangements. Failure to do so will enhance the possibility of legal action. Have the letter relating to this action reviewed by your legal counsel.

IMPROPER ACCELERATION OR FORECLOSURE

When a lender takes action against a borrower, either by accelerating a loan or taking possession of collateral, it is an extremely serious event. Even if the loan is in default, this event may result in legal actions against the lender. A court might find that the lender had acted in bad faith.

Improper Acceleration or Foreclosure Risk

If you continually accept delayed payments from a borrower, you may be deemed to have, by your course of dealing, modified the terms of the loan agreement. You will lose the right to accelerate in the future based on delayed payments with that borrower.

Protecting the Lender

You must give adequate notice to a borrower before you can call a loan in default. You can then take possession of collateral if the problem is not resolved. This rule may apply even if you have a loan agreement in place that says that notice is not required. Always consult with your legal counsel before you demand payment on a loan.

THE EXCHANGE OF CREDIT INFORMATION

Financial Institutions exchange credit information on a regular basis with their borrowers’ customers or other third parties. Your financial institution may incur liability if an individual responding to a credit information request makes representations or omissions of material facts that are false at the time. The institution may also have liability if the person does not exercise reasonable care and diligence to see that the information is accurate. The plaintiff would have to prove the following:

• Misrepresentation or omission of fact that is material or significant.
• Failure to exercise that degree of diligence and expertise the public expects of reasonably competent financial institution representatives.

• Reasonable reliance by the plaintiff on the institution’s misrepresentation or omission.

• Damages incurred as a direct and proximate result of such reasonable reliance.

**Protecting the Financial Institution**

To limit the possibility for litigation in this area:

• Refer all credit inquiries to a central group or single individual that can assure consistency and standardization.

• Make a record of who called or wrote requesting information, when the contact occurred, what was asked, and finally, how the financial institution responded.

• Be sensitive to the implied agreement that exists between you and your borrowers regarding confidentiality. Get an agreement from your borrower that you can release information to those who appear to have a legitimate business reason for inquiring.

**Breach of Fiduciary Duty**

Borrowers have not often raised this claim successfully. They are generally required to prove that the individual handling their account was perceived to have knowledge superior to that of the borrower and used that knowledge to pressure the borrower to make decisions that benefited the lender to the detriment of the borrower.

*Example:* The president of a small financial institution in an agricultural community was asked to approve a loan to a local cattleman. The president said he was sure the cattleman’s ranching activities would improve if he would purchase a registered bull owned by the president. The bull was purchased and the loan was made. If the bank had to sue to collect the loan, the cattleman could counter with a claim that the president had breached his fiduciary duty.
The Credit and Lending Dictionary

A

ABL: Asset Based Lending.

Absentee Owner: landlord who does not reside in his or her rental property.

Absorption Period: actual or expected period of time required from the point when a property is initially offered for purchase or use by its ultimate users until all portions offered for sale have been disposed of or stabilized occupancy has been achieved. Although marketing may commence prior to completion of construction, most forecasters view the absorption period as the period from completion of construction until all portions offered for purchase or use by its ultimate users have been disposed of or stabilized occupancy has been achieved. It is not necessarily equal to either the normal marketing period or investment-holding period for a property.

Abstract of Title: brief statement of the legal evidences of real estate ownership. An abstract of title gives the history of a parcel of land, starting with the original grant and following through each transfer of title to the present titleholder. It also recites all mortgages outstanding on the property and any defects that would cause a cloud on the title. See also Cloud on Title.

Abundance of Caution: the taking of collateral over and above the value of the debt as a precaution against the potential for the collateral offered having less value than originally anticipated.

Accelerate: the action by a note holder, bondholder, mortgage holder or contract to declare the remaining balance due and payable immediately.

Acceleration Clause: provision in note, bond, mortgage, or contract that allows holder to declare remaining balance due and payable immediately upon default in an obligation. Usual cause of default is failure to pay interest or principal installments in a timely manner or adverse change in financing conditions or failure to meet loan covenants. Refer Events of Default.

Acceptance: drawee’s signed agreement to honor draft as presented, which consists of signature alone, but will frequently be evidenced by drawee writing word “accepted,” date it is payable, and signature. Sometimes called Trade Acceptance or Banker’s Acceptance, depending upon function of acceptor.

Access to Capital: the ability of a company or institution to raise equity or debt in the form of private or public investment, loans, or grants for the purpose of generating funds for start-ups, research and development, capital expenditures, acquisitions, growth or other cash consuming type activities. Access sufficiency is critical to meeting financial forecasts.
Accommodation: 1. lending or extending credit to borrower. 2. loan or commitment to lend money.

Accord and Satisfaction: agreement between two or more persons or entities that satisfies or discharges obligation or settles claim or lawsuit. Generally involves disputed matter in which one party agrees to give and other party agrees to accept something in satisfaction different from, and usually less than, that originally asked for.

Account: 1. statement showing balance along with detailed explanation covering debits and credits. 2. right of payment for goods sold or leased or for services rendered on open account basis. 3. summarized record of financial transaction. 4. customer.

Accountant: person in charge of and skilled in the recording of financial transactions and maintenance of financial records. Defined term used herein collectively refers to Chartered Accountant, Certified General Accountant, Certified Management Accountant or Chartered/Certified Public Accountant.

Accountants/Auditors Opinion Letter: an attendant memorandum prepared by an Auditor expressing specific features and reliability associated with an audited financial statement. Opinion Letters generally are classified in one of four categories: Unqualified, Qualified, Disclaimer, or Adverse. A second form of opinion letter is called the “Management Letter.” This memorandum is presented directly to management and addresses internal controls that otherwise would not have material effect on the financial statements.

Accounting: 1. theory and system of classifying, recording, summarizing, and auditing books of firm. 2. art of analyzing, interpreting, and reporting financial position and operating results of business.

Account Manager: 1. sometimes called Relationship Manager or Account Officer. 2. person responsible for overseeing all matters relating to a specific client or group of customers.

Account Number: unique identification number used to designate specific customer.

Accounts Payable: short-term liability representing amounts due trade creditors.

Accounts Payable Days: an asset management ratio used to determine the average number of days cost of goods sold is in non cash credit status used both as a measurement in operating cash flow and accrual performance analysis. The ratio: Accounts Payables divided by Cost of Goods Sold times 365 with the product expressed in days.

Accounts Payable Department: section of business office responsible for processing open account balances and paying amounts owed for goods and services purchased.

Accounts Receivable: money due to a business by its customers for goods sold or services performed on open account (or credit). Usually refers to short-term receivables.

Accounts Receivable Aging Report: report by customer that lists age of accounts receivable generally by 30-day intervals from invoice or due date. See also Aging of Accounts Receivable.
Accounts Receivable Days - Days sales in receivables - Days sales outstanding (DSO) – Collection Period: an asset management ratio that measures the average length of time required to collect from customers on credit sales. The ratio: Receivables divided by Net Sales times 365 with the product expressed in days.

Accounts Receivable Financing: form of secured lending in which borrowings are typically limited to percentage of receivables pledged as collateral.

Accrual Accounting: basis of accounting in which expenses are recorded when incurred and revenues are recognized when earned, regardless of when cash is actually paid or received.

Accrue: 1. something gained, added, or accumulated, such as profit from a business transaction. 2. right to sue has become exercisable.

Accrued Expenses: short-term liabilities that represent expenses for goods used but not yet paid.

Accrued Income: income earned but not yet collected.

Accrued Interest: interest accumulated since last interest payment due date. As an asset, it is interest earned on an investment that has not yet been received, and as a liability it is interest payable on a debt that has not yet been paid.

Accrued Liabilities: expenses or obligations for goods or services incurred but not yet paid.

Accumulated Depreciation or Depletion: the cumulative charges against the fixed assets of a company for wear and tear, obsolescence, or the depletion of a natural resource (such as minerals or oil).

ACH: see Automated Clearinghouse.

Acid Test: ratio between company’s most liquid assets (generally, cash/cash equivalents and accounts receivable) and current liabilities that represents the degree to which current liabilities can be paid with those assets. Also referred to as Quick Assets Ratio or Quick Ratio.

Acknowledgment: 1. declaration making known receipt of something done or to be done; confirmation of receipt of order or of terms of contract. 2. statement of notary or other competent officer certifying that signature on document was personally signed by individual whose signature is affixed to instrument.

Acquisition: merger or taking over of controlling interest of one business by another.

Acquisition and Development Loan: loan made for the purpose of purchasing a property and completing all on-site improvements such as street layout, utility installation, and community area grading necessary to bring the site to a buildable state.

Acquittal: 1. release from obligation or contract. 2. to have accusation of crime dismissed by some formal legal procedure.
Active Account: 1. customer who makes frequent purchases. 2. bank account in which regular deposits or withdrawals are made.

Activity Charge: service charge imposed for check or deposit activity or any other maintenance charge.

Act of God: event that could not be prevented by reasonable foresight, is caused exclusively by forces and violence of nature, and is uninfluenced by human power (storm, flood, earthquake, or lightning).

Additional Dating: means of extending credit beyond normal sales terms, granted to induce buyers to place orders in advance of season or for other special reasons. See also Advance Dating and Dating.

Adjudication: 1. judgment rendered by court, primarily used in bankruptcy proceedings. 2. the process of assessing risk and making the decision to approve or decline a loan.

Adjustable Interest Rate: interest rate on loan that may be adjusted up or down at specific intervals. Index used in determining adjusted interest rate and potential frequency of adjustments must be stated in loan documents.

Adjustable Rate Mortgage: loan is pursuant to an agreement executed at the inception of the loan that permits creditor to adjust interest rate from time to time based on a specific interest rate index.

Adjuster: Person who deals with insured party to settle amount of loss, claim, or debt.

Adjustment: 1. settlement of disputed account. 2. change or concession in price or terms. 3. determining amount one is to receive in settlement of claim. 4. in accounting, entry made to correct or compensate for error or difference in account.

Advance: 1. payment made before it is due. 2. disbursement of loan proceeds.

Advance Dating: additional time granted customers to pay for goods received and to earn available discounts. See also Additional Dating and Dating.

Adverse Opinion of a Financial Statement: an Auditor’s opinion that departures from GAAP are too material to allow even a qualified opinion.

Advertising Allowance: promotional discount in price or payment given customers who share expense of advertising supplier’s product.

Affidavit: voluntary written statement of facts pertaining to a transaction or event, signed under oath and witnessed by an authorized person.

Affiliate: business entity connected with another through common ownership or management, usually responsible for payment of its own obligations.
After-Acquired Property: security interest by which secured creditor automatically obtains interest in assets that debtor acquires after lien had been filed.

Agency: legal relationship between two parties in which one is authorized to act for another.

Agent: person legally authorized to act for another.

Agent Bank: formal designation that applies to a bank responsible for negotiating, structuring, and overseeing a loan or commitment to a borrower in which more than one bank is involved. See also Lead Bank.

Aggregate Balances: combined total of two or more demand deposit accounts, money markets, or time certificates of deposit. Term can also be applied to credit facility totals.

Aging of Accounts Receivable: accounting record of customer’s receivables showing how long receivables have remained unpaid beyond regular terms of sale. Used as basis for advancing credit.

Agreement: contract involving an offer and an acceptance between two or more parties, governing the terms of the contract and binding on the parties to the agreement (e.g., a loan agreement, security agreement, or guaranty).

Air Lease: lease of the right of use, control, or regulation of air space over a parcel of real estate.

Air Rights: rights associated with the use, control, or regulation of air space over a parcel of real estate.

AKA: see Also Known As.

Alberta Guarantees Acknowledgement Act: a law that requires certification by a notary public that a guarantor has examined the guarantee, understands the contents and has acknowledged executing the same. Refer Acknowledgement.

Allegation: statement of party to action, setting out what he or she intends to prove or contend.

ALLL: see Allowance for Loan and Lease Losses.

Allocation: sub-limit within a total credit facility that is to be used for a specific purpose.

Allonge: paper attached to a negotiable instrument for additional endorsements or other terms and conditions.

Allowance: accounting provision used to set aside amounts for depreciation, returns, or bad debts.

Allowance for Bad Debts: contra account against which uncollectible receivables are charged. See also Bad Debt Reserve.
Allowance for Loan and Lease Losses (ALLL): contra account, generally found on asset side of balance sheet as deduction from total loans outstanding; amount is intended to cover future losses of loans currently in the financial institution’s portfolio. The ALLL should be adjusted monthly, concurrently with the generation of current financial statements.

All Present and After Acquired Property: a common form of phrase under PPSA to describe assets secured at the time the security is given and any property of that type that the borrower acquires after the fact. For example, can refer to such things as “All present and after acquired personal property”, or “All present and after acquired computer equipment”.

Also Known As (AKA): sometimes used to designate fictitious trade style or name.

Altered Cheque: cheque on which original entries have been changed (date, payee, or amount); financial institutions generally refuse to honor or pay checks that have been altered.

Amend: to correct, add to, or alter legal document.

Amicus Curiae: friend of court; uninvolved third party who intervenes in lawsuit, with court’s permission, to introduce information or arguments in respect to the issue or principle of law to be decided.

Amortization: 1. the gradual reduction of a debt by means of periodic payments sufficient to meet current interest and extinguish the debt at maturity. When the debt involves real property, often the periodic payments include a sum sufficient to pay taxes and insurance on the property. 2. the allowable annual tax deduction for an intangible asset over the period owned as prescribed by Canada Revenue Agency or annual expense for accounting purposes as prescribed by GAAP.

Amortization Period: the period of time over which the loan would be repaid in full assuming equal and regular payments are made. The payments in this context include an allocation of both principal and interest and can be determined using a financial calculator. If interest rates change, either the payment amounts or the amortization period must change.

Amortization Schedule: schedule of periodic payments of principal and interest that will reduce the loan balance. It may provide for payments that will not extinguish the debt by the end of the stated maturity. The amortization schedule simply indicates the outstanding balance, or Balloon Payment, will become due and payable at maturity.

Amortization Tables: calculation charts showing amounts required periodically to discharge debts over various periods of time and at different interest rates.

Amortize: 1. write off the value of an intangible asset over the period owned for tax purposes. Note that for financial accounting purposes, GAAP requires that the account be reviewed on an annual basis and written down to its realizable value. 2. reduce or pay off debt or obligation by making periodic payments of principal.

Amortized Mortgage Loan: mortgage loan that provides for repayment within a specified time by means of regular payments at stated intervals (usually monthly, quarterly, or semiannually) to reduce the principal amount of the loan and to cover interest as it is due.
Anchor Tenant: major tenant in a shopping center or office building representing a large portion of leasable space and a primary draw for the property.

Annual Percentage Rate (APR): annual cost of credit expressed as percentage; creditors are required under the Bank Act to disclose true annual interest on consumer loans, as well as the total dollar cost and other terms of loan. Regional Consumer Protection Legislation also has similar requirements.

Annual Report: yearly report detailing a company’s comparative financial and organizational conditions.

Annuity: series of fixed periodic payments made at regular intervals.

Anti-deficiency: in some Jurisdictions the lender is restricted to pursuing one course of action or remedy in the collection of a defaulted loan. The lender can either pursue repayment through the security or through the borrower, but not both. Specific examples include the Law of Property Act. If a mortgage with an individual is not insured by Canada Mortgage and Housing Corporation (CMHC), the lender can either seize the property or sue the owner, but cannot sue the owner for any deficiency if the sale of the property results in a shortfall. If the mortgage is insured by CMHC, the lender can seize the property and sue for any deficiency. You should make sure you understand the various rules in your Jurisdiction.

Antecedent Credit Information: historical record of significant business information concerning individuals who are involved in ownership or management of business enterprise.

Anticipation, Right of: privilege given the mortgagor, by a provision in the mortgage instruments, to pay all or any portion of the outstanding balance of the obligation prior to its due date without penalty.

Appeal: complaint made to higher court by either plaintiff or defendant for court’s review, correction, or reversal of lower court’s decision.

Appearance: coming into court formally as plaintiff or defendant in lawsuit.

Appraisal: 1. opinion of current value of real or personal property based upon cost of replacement, market, income, or fair value analysis. 2. written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.¹

Appraisal Institute of Canada: the national organization of professional real estate appraisers. It grants the use of the CRA (Canadian Residential Appraiser) and the AACI (Accredited Appraiser of Canada Institute and the P.App. Professional Appraiser) designations. It has provincial associations in all Provinces.

¹ Source: OCC Appraisal Regulation 12CFR Part 34
**Appraised Value:** an estimate by an appraiser as to the value of an asset based upon predetermined criteria involving an interpretation of facts, experience, and current market conditions. The resulting value may be expressed in different ways such as - Market, Orderly Liquidation or Quick Sale value based on the length of time necessary to convert the asset to cash.

**Appreciation:** increase in value of asset over its cost due to economic and other conditions. Property that increases in value as result of improvements or additions is not considered to have appreciated.

**Appropriation:** sum of money designated for a special purpose only.

**APR:** See *Annual Percentage Rate*.

**Arbitration:** submission for settlement of disputed matter, by nonjudicial means, to one or more impartial or disinterested third persons selected by disputants.

**Arm’s Length:** business transaction between two or more parties that is open, sincere, and without personal influence, favoritism, or close relations.

**Arrangement or Proposal:** plan for corporate reorganization for rescheduling or extension of time for payment of unsecured debts, such as an arrangement under the Companies’ Creditors Arrangement Act or the Bankruptcy and Insolvency Act.

**Arrears:** total or partial debt amounts that remain unpaid and past due.

**Articles of Agreement:** any written statement or contract, terms to which all parties consent.

**Articles of Incorporation:** formal papers that set forth pertinent data for formation of corporation and are filed with the appropriate Jurisdictional agency.

**As-Is Value:** appraisal term referring to the value of property as it exists at the present time. See *Value As Is*.

**As-Built-Out Value:** see *Value Upon Completion*.

**As-Completed Value:** appraisal term referring to the value of property at the time of completion of construction.

**As-Stabilized Value:** appraisal term referring to the value of property upon completion of construction and leasing to the point of stability.

**Assess:** 1. fix rate or amount. 2. set value of real and personal property, as for tax purposes.

**Assessed Value:** in the case of real property, value set by government agency for purpose of levying taxes.

**Assessment:** charge levied against property or persons by public authority. See also *Special Assessment*. 
Asset: 1. anything owned having monetary value. 2. item listed on left-hand side of balance sheet representing cash, or property, real or personal, belonging to an individual or company and convertible to cash or that will result in a decreased use of cash at some point in the future (i.e. prepaid expenses).

Asset Based Lending: a form of commercial lending designed to finance the working capital needs of a borrower whose operating cash flow may not support traditional debt service. Although primary repayment is cash flow a strong reliance exists on company assets as collateral. Formal monitoring and controls are used to mitigate credit risk.

Asset Efficiency: a measurement of how much revenue can be extracted from investments in assets. Various ratios are used for this measurement including Return on Equity, Return on Assets, Total Asset Utilization, Net Fixed Asset Turnover, Days Sales Outstanding, Inventory Turns, and Sales to Net Working Capital

Assigned Account: 1. account receivable pledged by borrower to factor or lender as security. 2. past-due customer whose account has been placed with collection agency.

Assignee: person to whom some rights, authority, or property is assigned.

Assignment: 1. written contract for transfer of one’s title, legal rights, or property from one person to another. The one who transfers the right is the assignor; the one to whom the right is transferred is the assignee. 2. in some states, form used to transfer claim to agency that undertakes collection of account for benefit of assigning creditor.

Assignment for the Benefit of Creditors: liquidation technique in which an insolvent debtor goes out of business and an assignee facilitates the transfer of the insolvent debtor’s estate for administration and payment of debts. Property transferred to assignee places such assets beyond control of debtor or reach of creditors.

Assignment of Claim: claim assigned to third party for collection.

Assignor: 1. one who transfers claim, right, or property. 2. individual, partnership, or corporation making assignment.

Assumed Liability: acknowledgment of responsibility for payment of obligation by third party.

At Sight: words used in negotiable instrument directing that payment be made upon presentation or demand.

Attached Account: legally frozen account on which payments have been suspended; release or disbursement of funds can be made only after court order.

Attachment: 1. legal writ or process by which debtor’s property (or any interest therein) is seized and placed in custody of law. 2. supplemental data provided as clarifying information to a document.

Attest: bear witness; affirm that a document is true or genuine.
Attornment Agreement: document used to gain acknowledgement from a tenant that it will accept a lien holder as its landlord in the event of a foreclosure.

Attorney-in-Fact: person who, as agent, is given written authorization by another person to transact business for his or her principal out of court. See also Power of Attorney.

Attorney of Record: lawyer whose name must appear in permanent court records as person acting on behalf of party in legal matter.

Auction: public sale of property that is sold to highest bidder.

Audit: to examine firm’s records, accounts, or procedures for purpose of substantiating or verifying individual transactions or to confirm if assets and liabilities are properly accounted for, including income and expense items.

Audited Financial Statements: financial statements that have been examined by an independent Auditor to determine if the financial statements present fairly the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Auditor: an independent person who deals with examination and verification of financial accounts and with making financial reports. Defined term used herein collectively refers to Chartered Accountant, Certified General Accountant and Certified Management Accountant in Canada or Chartered/Certified Public Accountant in the U.S.

Auditor’s Report: part of complete set of financial statements that explains degree of responsibility that the Auditor assumed for expressing an opinion on management’s financial statements and assurance that is provided by said opinion.

Automated Cash Application: computerized procedures enabling payments to be quickly and automatically applied to accounts receivable.

Automated Clearing Settlement System (ACSS): computer-based clearing and settlement facility provided by the Canadian Payments Association for interchange of electronic debits and credits among financial institutions. Membership includes chartered banks, trust and loan companies and some credit unions and caisses. ACSS entries can be substituted for cheques in recurring payments such as mortgages or in direct deposit distribution of federal and corporate benefits payments.

Available Balance: checking account balance that the customer actually may use; that is, current balance less deposits not yet cleared through the account.

Average Collected Balances: average dollar amount on deposit in checking accounts defined as the difference between ledger balance and deposit float, or those deposits posted to the account but having not yet cleared the financial institution upon which they are drawn. See also Uncollected Funds.

Average Collection Period: average number of days required to convert accounts receivable to cash.
**Average Daily Balance:** average amount of money that depositor keeps on deposit when calculated on daily basis.

**B/A:** Bankers’ Acceptance

**Backdating:** predating document prior to date on which it was drawn.

**Backlog:** amount of revenue expected to be realized from work to be performed on uncompleted contracts, including new contractual agreements on which work has not begun.

**Bad Cheque:** A cheque issued for payment on an account in an amount greater than funds available in the account. It is an offence under the Criminal Code of Canada to write cheques for which there are insufficient funds.

**Bad Debt:** account receivable that proves uncollectible in normal course of business; full payment is doubtful.

**Bad Debt Ratio:** ratio of bad debt expense to sales, used as measure of quality of accounts receivable.

**Bad Debt Reserve:** reserve or provision for accounts receivables to be charged off company’s books based on historical levels of bad debts or industry averages.

**Balance:** amount owed or unpaid on loan or credit transaction. Also called outstanding or unpaid balance.

**Balance Due:** total amount owed after applying debits and credits of account.

**Balance Sheet:** financial statement listing the assets, liabilities, and owner’s equity of a business entity or individual as of a specific date.

**Balloon Mortgage:** mortgage with maturity less than the amortization period used to determine the principal and interest payments.

**Balloon Payment:** lump-sum payment of principal and sometimes accrued interest, usually due at end of term of installment loan in which periodic installments of principal and interest did not fully amortize loan.

**Band of Investment:** analytical technique incorporating the cost of debt and equity to determine a weighted average rate to capitalize a cash flow from a property to a value estimate.

**Bank:** In Canada, banks are defined by reference to Schedule I and Schedule II of the Bank Act.

**Bank Draft:** sight or demand draft (order to pay) drawn by a bank (drawer) on its account at another bank (drawee).
Banker’s Acceptance (B/A): draft or order to pay specified amount at specified time drawn on individuals, business firms, or financial institutions; draft becomes accepted when a financial institution formally acknowledges its obligation to honor such draft, usually by writing or stamping “Accepted” on face of instrument. When accepted in this manner, draft becomes liability of bank. See also Draft and Time Draft. Refer Dimension 6 for differences between Canadian and U.S. B/A’s.

Bank of Canada: the central bank responsible for conduct of monetary policy and promotion of the financial and economic welfare of Canada.

Bank of Canada Rate: the rate at which the Bank of Canada makes short-term advances to the chartered banks, to savings banks governed by the Quebec Savings Bank Act, to all members of the Canadian Payments Association and to investment dealers who are money market "jobbers". The Bank of Canada Rate is set at the upper end of the Bank of Canada's announced operating band for overnight funding.

Bank for International Settlements (BIS): an international organization that serves as a bank for central banks. Its primary role is to promote stability through international monetary and financial co-operation. Through its Basel Committee, works to standardize bank regulations, including the requirement for banks in participant countries to conform to uniform capital requirements.

Bank Overdraft: a form of loan to a depositor created when a cheque is presented for collection for which there are not sufficient funds on deposit to make normal payment. Financial institution may honor such cheque or return it as NSF.

Bankers’ Confirmation: formal request, usually by a firm’s accountant to the firm’s bank, requesting confirmation with respect to account balance information, security, etc.

Bankrupt: debtor who is unable to meet debt obligations as they become due or is insolvent and whose assets are administered for benefit of creditors.

Bankruptcy: Legal action taken under the Bankruptcy and Insolvency Act (BIA) by or against an insolvent debtor who is unable to meet obligations as they become due. The bankrupt, if given discharge, is released from further liability of most debts listed as of the date of the bankruptcy filing.

• Voluntary Bankruptcy: any individual, partnership, corporation, estate, trust, or governmental unit may be afforded protection of debtor under Bankruptcy & Insolvency Act by filing petition.
  Involuntary Bankruptcy: involuntary petition can be filed in bankruptcy court by one or more creditors. Petitioning creditors’ claims must aggregate at least $1,000 in excess of value of any collateral of debtor. Involuntary petition must allege that the debtor has committed an act of bankruptcy (as defined in the BIA) within the six months preceding the filing of the petition.

Bankruptcy and Insolvency Act: (BIA): a federal act governing bankruptcy and insolvency.
**Bankruptcy Judge:** presiding judge of court in which bankruptcy cases are heard. Duties of judge include supervising administrative details of bankrupt estates and ruling on all matters involving debtor-creditor problems.

**Barriers to Entry:** situations specific in a given industry that create difficulty for new competitors attempting to enter the market.

**Basis:** 1. number of days used in calculating interest earned in investment or interest payable on bank loan. Also called accrual base. 2. original cost of asset plus capital improvements from which any taxable gains (or losses) are determined after deducting depreciation expenses.

**Basis Point:** 1/100th of a percent; 100 basis points equal 1%.

**Bearer:** negotiable item (check, note, bill, or draft) in which no payee is indicated or payee is shown as “cash” or “bearer.” Item is payable to person in possession of it or to person who presents it for payment.

**Bearer Paper:** instrument that is made “payable to bearer.” When negotiable instrument is endorsed in blank, it becomes bearer paper and can be transferred by delivery since it does not require endorsement.

**Benchmarks:** specific quantifiable measures of property status, cash flow, or progress toward expected levels of performance, used to monitor the strength of real-estate-based repayment sources.

**Beneficiary:** 1. person or organization named in will to inherit or receive property. 2. person or organization to whom insurance policy is payable. 3. person or organization for whose benefit trust is created.

**BIA:** Bankruptcy and Insolvency Act

**Bid Bond:** bond issued by surety on behalf of contractor that provides assurance to recipient of contractor’s bid that if bid is accepted, contractor will execute contract and provide performance bond. Under bond, surety is obligated to pay recipient difference between contractor’s bid and bid of next lowest responsible bidder if bid is accepted and contractor fails to execute contract or to provide performance bond.

**Bill and Hold Invoices:** an invoice generated before the actual service or product has been rendered or delivered. This condition may create an overstatement of revenue and accounts receivable.

**Billing Cycle:** number of days between payment due dates.

**Bill of Costs:** certified itemization of costs associated with lawsuit.

**Bill of Exchange:** an unconditional written instrument from one person to another person to pay a designated amount of money.
**Bill of Lading**: written instrument signed by common carrier or agent identifying freight and representing both receipt and contract for shipment. It must show name of consignee, description of goods, terms of carrier’s contract, and directions for assigning to specific person at specific place. In form of negotiable instrument, it is evidence of holding title to goods being shipped.

**Bill of Sale**: written instrument evidencing transfer of title of specific personal property to buyer.

**Bills of Exchange Act**: is the federal act regulating bills of exchange in Canada.

**Binder**: 1. written agreement that provides temporary legal protection pending issuance of final contract or policy. 2. temporary insurance contract; may be oral or written; also called cover note.

**BIS**: Bank for International Settlements.

**Blank Endorsement**: endorser’s writing on check, promissory note, or bill of exchange without indicating party to whom it is payable. Endorser merely signs his or her name, making the instrument “payable to bearer.” Also called endorsement in blank.

**Blanket Coverage**: property coverage applicable to group of exposures (buildings, inventory, equipment, etc., combined or individually, at one or more locations), in single total amount of insurance; contrasts with Specific Coverage.

**Blanket Mortgage**: mortgage secured by two or more parcels of real property, frequently used by developers who acquire large tract of land for subdivision and resale to individual homeowners. Also called blanket trust deed.

**Blue Sky Law**: law that regulates the distribution of securities to the public.

**Bond (as used in mortgage lending)**: instrument given by a mortgage borrower evidencing indebtedness and containing his or her promise to repay the obligation in accordance with the terms of the mortgage contract. See also Fidelity Bond and Surety Bond.

**Bonded Warehouse**: federally approved warehouse under bond for strict observance of revenue laws; used for storing goods until duties are paid or property is otherwise released. Bonded warehouse assures owner of property that operators of warehouse are insured against loss by fraud and will keep proper inventory and accounting of goods in transit.

**Bonding Agent (surety)**: an individual or organization that represents a client on financial and management matters and gathers the information that a surety company will need to underwrite for issuing of surety or other performance related bonds.

**Bonding Company**: company authorized to issue bid bonds, performance bonds, labor and materials bonds, or other types of surety bonds.

**Book Value**: 1. company’s net worth calculated by adding total assets minus total liabilities. 2. value of asset (cost plus additions, less depreciation) shown on books or financial report of an entity.
**Borrower’s Certificate:** document required under a loan or other agreement to be submitted by the borrower or another designated party to certify the value of collateral and or compliance with the terms of the agreement.

**Borrowing Availability:** The amount of funds available for a lender to loan to a borrower at a specific time (see Borrowing Base).

**Borrowing Base:** A term generally used in secured or formula based commercial working capital finance indicating the amount of loan funds that are available based on a pre-defined formula.

**Bottom Line:** (colloq.) final price, net profit, or end results.

**Branch Banking:** multi-office banking. Branch is any banking facility away from bank’s main office that accepts deposits or makes loans.

**Breach of Contract:** failure to fulfill terms of contract, in part or whole.

**Breach of Warranty:** 1. failure to fully disclose information about condition of property or insured party. 2. failure to perform as promised.

**Break-Even Analysis:** A method of determining the number of units that must be sold at a given price to recover all fixed and variable costs. As Lenders, it is important for the break-even analysis to include scheduled payments of our loans.

**Break-Even Point:** 1. point at which total sales is equal to total expenses. May be expressed in units or dollars. 2. amount received from sale that exactly equals amount of expense or cost.

**Bridge Loan:** loan that provides liquidity until defined event occurs that will generate cash, such as sale of noncurrent asset, replacement financing, or equity infusion.

**Broker:** middleman who brings together buyers and sellers of the same security or commodity and executes their orders, charging a commission for the service.

**Build-out:** Construction of interior-finish work to a tenant’s specifications.

**Bulk Market Value:** A misnomer; see also *Gross Selling Price* and *Value to a Single Purchaser*.

**Bulk Sales Acts:** statutes designed to prevent defrauding of creditors through sale in bulk of merchant’s goods. Not all Jurisdictions have Bulk Sales Acts.

**Bullet Debt (Bullet Maturity):** securities that carry fixed rates of return and are non-callable. Rate or yield is calculated based on actual purchase price by the investor in relationship to interest payments (or coupon payments) and the principal payment to be received at maturity.

**Bundle of Rights:** collection of rights a property owner enjoys through ownership of property in fee simple, conveying the right to use, sell, improve, lease, or occupy.
**Burden of Proof:** 1. duty of producing sufficient evidence to prove position taken in lawsuit. 2. necessity of proving fact or facts as to truth of claim.

**Business:** 1. commercial, industrial, or mercantile activity engaged in by individual, partnership, corporation, or other form of organization for purpose of making, buying, or selling goods or services at profit. 2. occupation, profession, or trade.

**Business Corporations Act:** federal legislation governing business of corporations in Canada.

**Business Failure:** 1. suspension of business resulting from insolvency or bankruptcy. 2. inability to fulfill normal business obligations.

**Business Interruption Insurance:** property insurance written to cover loss of profits and continuing expenses as result of shutdown by insured peril; exposure is classified as consequential loss. Also called *earnings insurance*.

**Buyer’s Market:** market condition in which supply exceeds demand, which causes prices to decline.

**Buy Out:** to purchase at least a controlling percentage of a company’s stock to take over its assets.

**Bylaws:** set of rules or regulations adopted to control internal affairs of organization.

**C**

**C’s of Credit:** the “Five C’s” of credit. A long standing means of evaluating a customer by investigating: *Character, Collateral, Capacity, Conditions, and Capital*.

**CA:** see Chartered Accountant

**Calendar Year:** 12-month accounting period ending December 31.

** Callable Loan:** loan payable on demand.

**Call Under the Guarantee:** refers to the bank asserting its rights to collect payment under a guarantee obtained to support an extension of credit.

**Canada Deposit Insurance Corporation:** a federal Crown Corporation that provides insurance up to $60,000 per depositor for deposits at banks, trust companies and loan companies.

**Canada Mortgage and Housing Corporation:** a federal agency that insures residential mortgages.

**Canada Pension Plan:** a federally administered contributory retirement pension plan that pays benefits upon retirement based on earnings and contributions.
Canada Revenue Agency: a federal agency that administers tax laws for the Government of Canada and most Provincial and Territorial governments and various social and economic benefit and incentive programs delivered through the tax system.

Canada Small Business Financing Program: a federally supported program where qualified small business will be granted a loan or lease for which the Federal Government will guarantee 85% of the lender’s losses in the event of a default.

Canadian Accounting Standard Board: an independent board responsible for establishing accounting reporting standards under GAAP.

Canadian Bill of Rights: federal legislation for the protection of human rights and fundamental freedoms.

Canadian Environmental Protection Act: federal laws governing environmental safety, protection and clean up.

Canadian Payments Association (CPA): is an association governed by the Canadian Payment Act of Canada which operates national clearing and settlement systems to facilitate this flow of funds between institutions and mitigate risk to payment system participants.

Canceled Cheque: cheque that has been paid by a financial institution and on which financial institution has imprinted evidence of payment so that it cannot be presented again.

Cancellation Clause: provision in contract or agreement allowing parties to rescind agreement under certain conditions.

Capital Cost Allowance: is an accelerated rate of depreciation utilized for income tax purposes in Canada.

Capitalization Rate (Cap rate): the discount rate used to determine the present value of a stream of future earnings. In commercial real estate lending or other types of structured finance the resulting value is an indication of the worth of income producing properties or fixed assets.

Capacity: one of the “Five C’s” of credit; a customer’s ability to successfully absorb merchandise and to pay for the merchandise. Refers to customer’s ability to produce cash sufficient to meet obligations when due.

Capital: 1. one of the “Five Cs” of credit; refers to financial resources the customer has at the time order is placed and those that he or she is likely to have when payment is due. 2. amount invested in business by owners or stockholders. 3. owner’s equity in the business.

Capital Goods: commodities used to produce other goods, either consumer goods or other capital goods.

Capital Lease: a lease which meets several requirements that is an on balance sheet financing. The lessee acquires essential all of the economic benefits and risks of the lease and the lease must be shown as an asset on the balance sheet, as must the corresponding liability.
**Capitalization:** process of converting an annual or other periodic payment into an equivalent capital amount.

**Cash:** 1. money readily available for current expenditures; usually consists of cash on hand or money in a financial institution. 2. money equivalent, such as check, paid at time of purchase. 3. any medium of exchange that the financial institution will accept at face value upon deposit.

**Cash After Debt Amortization:** calculated in a “Direct” Cash Flow Statement, it is that cash available to a concern after funding operations, meeting financing costs and debt payments due. It answers the question, was a concern able to generate sufficient cash from its operations to fund fixed asset acquisition and make long-term investments after meeting financing costs and long-term debt payments?

**Cash Basis Accounting:** basis of accounting in which revenues and expenses are reported in the income statement when cash is received or paid out for the time period in which the revenues and expenses occur.

**Cash Debt Service Ratio:** calculated from a “Direct” Cash Flow Statement it is the relationship between “Net cash after operations” and “Financing Costs”. i.e. Net Cash After Operations divided by Financing Costs. It answers the question “Was the concern able to meet debt service from cash generated by the business?”

**Cash Equity:** percentage of project cost required to be supplied by the borrower in cash.

**Cash Equivalents:** accounting term for actual cash on hand and total of bank deposits.

**Cash Flow:** is based on an activity format, which classifies cash inflows and outflows in terms of operating, investing, and financing activities.

**Cash Flow Coverage Ratio:** calculated from a “Direct Cash Flow Statement” it is the relationship between “Net Cash Income” and “Current Portion Long-Term Debt”. i.e. Net Cash Income divided by CPLTD. It answers the question, was a concern able to meet its long-term debt payments from internally generated cash?

**Cash Flow Statement:** a cash flow statement is an analysis of the cash inflows and outflows of an entity during a designated time period.

**Cash From Sales:** calculated in a “Direct Cash Flow Statement” it is that amount of cash generated from sales in a specific period after adjustment to sales for changes in the applicable balance sheet account. i.e. Accounts Receivable.

**Cashier’s Cheque:** cheque drawn on financial institution’s account, becoming direct obligation of the financial institution.

**Cash Management:** the execution of polices and procedures within an organization to maximize the inflows and control outflows of cash, recognizing that cash is generally a non earning asset investment. A set of products offered by banks and other financial service organizations to assist
clients in the management of cash through disbursement, reconcilement, collections services and information reporting.

**Cash Management Account:** special type of deposit service that permits corporate customers to invest cash in demand deposit account until needed for operations.

**Cash Production Costs:** calculated in a “Direct Cash Flow Statement” it is the total cost of production in a period after adjustment for changes in the balance sheet accounts applicable to production. i.e. Inventory and Accounts Payable.

**Cash Surrender Value:** in life insurance, amount payable under whole life policy when terminated by insured.

**Cash Throw Off:** identifies the cash available to a property owner from the NOI after debt service but before taxes.

**Casualty Insurance:** coverage for automobile, liability, crime, boiler and machinery, health, bonds, aviation, workers’ compensation, and other miscellaneous lines; contrasts with *Property Insurance*.

**CCAA:** Company Creditor Arrangement Act

**Certificates of Deposit:** a fixed income debt security issued by most chartered banks.

**Certificate of Insurance:** written statement issued by insurer indicating that insurance policy has been issued and showing details of coverage at time certificate was written; used as evidence of insurance.

**Certificate of Title:** certificate issued by a public official, commonly known as a registrar of land titles. Jurisdictions issue variations of these certificates, and each has its own meaning. For example, in Alberta a Certificate of Title establishes an indefeasible title in an indicated owner but that may not be the case in other Jurisdictions.

**Certified Cheque:** depositor’s cheque confirmed on its face as good by a financial institution and stamped “certified.” It is then dated and signed by an authorized officer of the institution. Such check becomes an obligation of the financial institution, which guarantees that it is holding sufficient funds to cover payment of cheque on demand.

**Certified Copy of Policy:** document that provides evidence of insurance as of certain date; coverage may be terminated or changed after certification.

**Certified General Accountant (CGA):** in Canada, one who has been trained to do accounting and who has completed the certification process and received title of CGA; title certifies holder’s qualification to practice accounting, audit, prepare reports, and analyze accounting information.

**Certified Management Accountant (CMA):** in Canada, one who has been trained to do accounting and who has completed the certification process and received title of CMA; title
certifies holder’s qualification to practice accounting, audit, prepare reports, and analyze accounting information.

**Certified Public Accountant (CPA):** in the U.S., one who has been trained to do accounting and who has passed state test and received title of CPA; title certifies holder’s qualification to practice accounting, audit, prepare reports, and analyze accounting information.

**CGA:** see Certified General Accountant

**CGL:** see *Comprehensive General Liability.*

**Character:** one of the “Five Cs” of credit; refers to evaluating qualities that would impel debtor to meet his or her obligations. Generally identified as customer’s reputation, responsibility, integrity, and honesty.

**Charge:** legal right or encumbrance to secure payment performance on property pledged as collateral until debt, which it secures, is satisfied.

**Charge-Off:** portion of principal balance of a loan or account receivable that an entity considers uncollectible; this amount may be partially or fully recovered in future. Also called a *Write-Off.*

**Chart of Accounts:** listing of all financial accounts or categories (usually numbered) into which business transactions are classified and recorded.

**Chartered Accountant (CA):** in Canada, one who has been trained to do accounting and who has completed the certification process and received title of CA; title certifies holder’s qualification to practice accounting, audit, prepare reports, and analyze accounting information. CA’s are the Canadian equivalent of a CPA.

**Chartered Bank:** Canadian banks that are Federally incorporated and regulated by the Bank Act.

**Chattel:** any property, movable or immovable, except a freehold estate in land. See also *Freehold Estate.*

**Chattel Mortgage:** mortgage on movable goods or equipment given as security for the payment of an obligation. See also *Mortgage.*

**Chattel Paper:** in most PPSA Jurisdictions is an interest in both real property and a revenue stream associated with it. Examples are Conditional Sales Agreements and leases.

**Cheque:** order on a financial institution for payment of funds from depositor’s account and payable on demand.

**Claim:** 1. action to recover payment, reimbursement, or compensation from entity legally liable for damage or injury.

**Claimant:** one who makes claim or asserts right.
Clean-down provision: A contractual provision typically found within working capital loan agreements that require the loan facility to be paid down at certain intervals (usually annually) and remain dormant for a specific period of time (normally for 30 days).

Cleanup: period during which particular loan or entire borrowing has been paid off; out-of-debt period required under line of credit.

Clearinghouse: association of financial institutions or security dealers created to permit daily settlement and exchange of checks or delivery of stocks and other items between members in local geographic area.

Closed-End Credit: consumer installment loan made for predetermined amount, calling for periodic payments of principal and interest over specified period or term. Finance charge may be fixed or variable rate. Borrower does not have option of obtaining extra funds under original loan agreement. Contrasts with Open-End Credit.

Closing a Mortgage Loan: consummation of a loan transaction in which all appropriate papers are signed and delivered to the lender; the making of the mortgage becomes a completed transaction; and the proceeds of the mortgage loan are disbursed by the lender to the borrower or on the borrower’s order.

Closing Charges: expenses or costs incurred in the sale, pledging, or transfer of property, such as recording fees and title examination fees, which must be provided for and distributed between the parties on consummation of the transaction.

Cloud on Title: is generally used to refer to a defect in the chain of title to real property that prevents the acceptance of that title in the market.

CMA: See Certified Management Accountant

Collateral: 1. one of the “Five C’s” of credit; refers to real or personal property that may be available as security. 2. Specific property that a borrower pledges as security for the repayment of a loan, agreeing that the lender shall have the right to sell the collateral for the purpose of liquidating the debt if the borrower fails to repay the loan at maturity. In the case of a loan against real property, the lender usually must go through what is often a lengthy and legally involved procedure to acquire title to the real estate that is collateral for the loan. See also Secured Loan.

Collateral Coverage: the amount of collateral that is required to support the total of borrowings at any point in time, usually expressed as an operating covenant within a secured or formula based loan agreement. Often stated as a ratio: Eligible collateral over specific loan debt with the quotient expressed as x:y.

Collateral Note: form of promissory note given for loan, pledging real or personal property as security for payment of debt.

Collectible: account capable of being collected.
Collection Agency: professional business service employed as agent to collect creditors’ unpaid (past due) accounts. Collection agency is usually compensated by receiving agreed upon contingent percentage of amount collected.

Collection Agency Report: report from collection agency that informs client of results of collection efforts, investigations, or recommendations.

Collection Charges: 1. fees charged by bank for collecting drafts, notes, coupons, or other instruments. 2. compensation paid to collection agency or attorney for collecting delinquent accounts.

Collection Item: 1. term for item received for collection that is to be credited to depositor’s account after payment. Most financial institutions charge special (collection) fees for handling such items. 2. past due account assigned for collection.

Collection Period: average number of days required for company’s receivables to be collected and converted to cash. Refer to Accounts Receivable Days.

Comaker: person who signs (and guarantees) note of another and by so doing promises to pay in full. See also Cosigner.

Comfort Letter: A statement offered by one organization or individual party to another providing assurance based on the perceived integrity and financial strength of the offering party that certain promises, conditions, or duties will exist or will be maintained by an associated third party. Comfort letters are a surrogate form of a guarantee and are generally legally enforceable dependent upon the language used in the document.

Commensurate: describes deposit balances that are in acceptable proportion to size of loan or commitment.

Commercial Debt: loan or obligation incurred for business purposes.

Commercial Paper: short-term securities such as notes, drafts, bills of exchange, and other negotiable paper that arise out of commercial activity and become due on a definite maturity date.

Commercial Property: real estate used for business purposes or managed so as to produce income from rents and leases.

Commitment/Committed Loan: 1. agreement between a financial institution and borrower to make funds available under certain conditions for a specified period of time. The financial institution has a legal requirement to fund if all of the conditions are met. 2. A Note to the Financial Statements describing a commitment that the company has made (for example, to purchase a significant asset, or a contractual agreement to supply a committed value of product).

Commitment Fee: lender’s charge for holding credit available, usually replaced with interest when funds are advanced, as in revolving credit. In business credit, commitment fee often charged for unused portion of line of credit.
Commitment Letter: letter from lender stating willingness to advance funds to named borrower, repayable at specified rate and time period, subject to escape clause(s) allowing lender to rescind agreement in event of materially adverse changes in borrower’s financial condition.

Committee Approval: credit is approved by several people acting as group.

Common Area Maintenance (CAM): expense of maintaining common areas such as elevators, foyers, and parking lots.

Community Property: property shared by husband and wife, each having one-half interest in earnings of other; form of joint property ownership in some Jurisdictions.

Common Law: body of law that was originated, developed, and administered in England.

Company Creditor Arrangement Act: a federal Act to facilitate compromises and arrangements between companies and their creditors.

Company’s Direct Cash Flow Statement: A Cash Flow Statement for a company covering a specific period generated in a format starting with Sales/Revenues, often referred to as a “Top Down” cash flow statement. It is constructed using the concerns income statement, eliminating non-cash items and including changes on balance sheet accounts.

Compensating Balance: demand deposit balance that must be maintained by borrower to compensate financial institution for loan accommodations and other services.

Competition Act: a federal act for the general regulation of trade and commerce in respect of conspiracies, trade practices and mergers affecting competition.

Compiled or Notice to Reader Statements: financial statements prepared by an outside third party (does not have to be an Accountant) based strictly upon the representations of the producing individual or business entity. The reader has no assurance that the statements have been prepared in accordance to GAAP. Caution must be exercised in using such statements for the purpose of financial analysis as the quality of such statements relate more directly to the integrity and skills of the producing company or individual and not the third party that produced the statements.

Compound Interest: interest calculated by adding accumulated interest to date to original principal. New balance becomes principal for additional interest calculations.

Comprehensive General Liability (CGL): policy form providing automatic coverage for all insured’s business operations; may include auto exposures; newer form of CGL is called commercial general liability.

Concentration Accounts: a centralized account to which funds collected at multiple locations are transferred.
**Concession:** 1. granting of special privilege to digress from regular terms or previous conditions. 2. allowance or rebate from established price. 3. business enterprise operated under special permission.

**Conditional Sales Contract:** contract for sale of goods under which possession is delivered to buyer but title retained by seller until goods are paid for in full or until other conditions are met.

**Conditions:** one of the “Five C’s” of credit; refers to general business environment and status of borrower’s industry.

**Condominium:** apartment building in which the apartments are owned individually and operated for mutual benefit.

**Conduit:** conduits provide a source of long-term, fully amortizing property refinancing that securitizes commercial mortgages. A conduit originates a pool of loans and creates securities backed by the payments and collateral for those loans. These securities are sold in the public markets to a variety of institutional, public, and private investors in the same way home mortgages have been securitized and available as a public investment vehicle for decades, providing liquidity to the commercial mortgage market and an additional source of refinancing to commercial real estate lenders.

**Confirmation:** 1. supplier’s written acknowledgment that he or she has accepted buyer’s order. 2. customer’s written verification of order previously placed. 3. proof verifying agreement or existence of assets and liabilities or claims against assets and liabilities.

**Consent Judgment:** judgment that debtor allows to be entered against him or her by motion filed with court.

**Consideration:** 1. element in contract without which contract is not binding; contract is generally not valid without consideration. 2. reason for contracting parties to enter into contract; act, promise, price, or motive for which agreement is entered into. 3. value given in exchange for benefit that is to be derived from contract. 4. compensation; exchange of consideration is usually mutual, each party giving something up to other.

**Consign:** to send or forward goods to merchant, factor, or agent for sale with title retained by seller and with payment delayed, generally until sale is made.

**Consignee:** person or entity to which goods or property is consigned or shipped; ultimate recipient of shipment.

**Consignment:** arrangement under which consignor (seller) remains owner of property until such time as consignee (buyer) pays for goods; usually consignee pays consignor when goods are sold or holds proceeds of sale in trust for benefit of consignor.

**Consignor:** 1. one who delivers shipment or turns it over to carrier for transportation and delivery. 2. one who consigns goods to be sold without giving up title.
**Consolidated OCF:** Operational Cash Flow of a group of concerns calculated on a “consolidated” basis. That is after eliminating any inter concern transactions.

**Consolidating Financial Statement:** combined statement of subsidiary and parent companies that shows complete statement for each entity without netting intercompany transactions. The statement includes a netting column providing information as to what intercompany accounts need to be netted to provide Consolidated Financial Statements.

**Constant:** usually expressed in decimal format, representing the ratio of annual debt service to total loan principal.

**Construction Lien:** is a lien on the interest of an owner in a premise by a person who has supplied services or materials to an improvement for an owner, contractor or subcontractor. The lien is for the amount of the services performed and becomes effective when the person first supplied materials or services.

**Construction Loan:** funds extended on the security of real estate for the purpose of constructing improvements on the property and usually advanced during the period of construction.

**Consumer Credit:** debt incurred for personal, family, or household use.

**Consumer Goods:** commodities whose ultimate use is to contribute directly to the satisfaction of human wants or desires—such as shoes and food—as distinguished from producers’ or capital goods.

**Consumer Protection Laws:** Jurisdictional laws that regulate the fair protection of consumers including details with respect to uniform methods of computing cost of consumer credit and disclosure of credit terms.

**Consumer Sale Disclosure Statement:** a generic form required to be provided by a creditor to its customer, disclosing finance charge details as required under Consumer Protection Laws, of the various Jurisdictions including such acts as the Fair Trading Act in Alberta.

**Contingent Fee:** fee to be paid only in event of specific occurrence, usually successful results. Arrangement, for example, in which collection agency will receive stated percentage of any amounts recovered or in which lawyer will receive payment only if successful in prosecuting lawsuit.

**Contingent Liability:** liability in which a person(s) or business(es) is indirectly responsible for obligations of a third party. Such indirect liability is usually established by guarantee or endorsement, and the liability holder may turn to guarantors or endorsers for satisfaction of debt. See also Endorsement and Guarantee.

**Contra Account:** account that partially or wholly offsets another account or balance.

**Contract:** agreement between two or more entities or legally competent persons that creates, modifies, or destroys legal arrangement.
Contractor: person who contracts to perform work or to supply materials under specified conditions.

Controller: person in business organization responsible for finances, internal auditing, and accounting systems in use in company’s operations.

Conventional Mortgage Loan: mortgage loan made directly to the borrower without government insurance or guaranty.

Conversion: process of consolidating or transferring data from one system to another.

Conveyance: 1. transfer of right, generally instrument transferring interest in real estate in form of deed. 2. transfer of property ownership (sometimes includes leases and mortgages) from one person or organization to another.

Cooperative: enterprise that is collectively owned and operated for mutual benefit.

Cooperative Credit Associations Act: federal legislation regulating Cooperative Credit Associations as defined therein.

Copyright: intangible right granted to author or originator by federal government to solely and exclusively reproduce or publish specific literary, musical, or artistic work for certain number of years.

Corporate Reorganization: see Bankruptcy.

Corporate Veil: convention that corporate organization insulates organization’s owners from liability for corporate activities.

Corporation: artificial person or legal entity organized under and treated by Jurisdictional laws, legally distinct from its shareholders and vested with capacity of continuous succession irrespective of changes in its ownership either in perpetuity or for limited term. It may be set up to contract, own, and discharge business within boundaries of powers granted it by its corporate charter.

Correspondent: organization or individual that carries on business relations or acts as agent with others in different cities or countries.

Cosigner: one of joint signers of loan documents. One who signs note of another as support for credit of principal maker.

Cost in Excess of Billings: is an asset related accounting term often used by construction or long term contract type producing enterprises in which revenues for individual contracts are recognized over the contract period under a percentage- of- completion accounting convention. Within this approach sales and gross margins are recognized as work is completed and actual cost incurred versus estimated cost for the total project. Revenues that will be recognized but not billed at a later date are capitalized as an asset under a category captioned cost in excess of billing.
**Cost of Funds:** dollar cost of interest paid or accrued on funds acquired from various sources within bank and borrowed funds acquired from other financial institutions, including time deposits, advances at the Bank of Canada, and Eurodollar deposits. Financial institution may use internal cost of funds in pricing loans it makes.

**Coupon:** the “interest” or amount of return due a bond holder, with payment made by the issuer, usually on a semiannual basis. The term is literal in that bonds historically came with attached coupons that could be torn or cut OFF and submitted for payment. Today coupons are generally stored and processed electronically.

**Coupon Rate:** the effective interest rate to be earned from a bond. (see Coupon)

**Covenant:** a formal pledge or promise, express or implied, in an agreement between the parties to a contract, particularly the parties to a deed or a mortgage.

**CPA:** see *Certified Public Accountant*.

**CPP:** Canada Pension Plan

**CPLTD:** Current Portion of Long Term Debt

**CRA:** see Canada Revenue Agency.

**Crash:** sudden sharp decrease in business activity that can negatively affect stock market volumes and prices.

**Credit:** 1. privilege of buying goods, services, or borrowing money in return for promise of future payment. 2. in bookkeeping, entry on ledger signifying cash payment, merchandise returned, or allowance to reduce debt. 3. accounting entry on right side of ledger sheet.

**Credit Analyst:** person who evaluates the financial history and financial statements of credit applicants to assess creditworthiness. Analysts are trained to evaluate applicant’s financial strength and to opine on the probability of full repayment, collateral adequacy, or whether a credit enhancement through a cosigner or guarantor is needed.

**Credit Application:** form completed by potential borrower and used by creditor to determine applicant’s creditworthiness.

**Credit Approval:** decision to extend credit.

**Credit Approval System:** internal methods by which credit decisions are made.

**Credit Bureau:** agency that gathers information and provides its subscribers with credit reports on consumers.

**Credit Checking:** examining and analyzing creditworthiness of customer by contacting references, reviewing credit reports, etc.

**Credit Department:** department within a financial institution that performs operations and credit support functions for underwriting activities. May include maintenance of credit files,
credit investigations, financial statement analysis and spreading, customers’ accounts receivable audits, lender training, portfolio reporting, facilitation of credit meetings, etc.

**Credit Enhancement:** enhancement to creditworthiness of loans underlying asset-backed security or municipal bond, generally to get investment-grade rating from bond rating agency and to improve marketability of debt securities to investors. There are two general classifications of credit enhancements:

- third-party enhancement, in which third party pledges its own creditworthiness and guarantees repayment in form of standby letter of credit or commercial letter of credit issued by a financial institution, surety bond from insurance company, or special reserve fund managed by financial guaranty firm in exchange for fee.
- self-enhancement, which is generally done by issuer through over-collateralization, that is, pledging loans with book value greater than face value of bonds offered for sale.

**Credit File:** creditor’s file that compiles information about customer including correspondence, credit memorandums and analyses, credit ratings, a credit history, payment patterns, and credit inquiries.

**Credit Granting:** approval and extension of credit to customer.

**Credit Inquiry:** request made by a financial institution or trade creditor concerning responding bank’s own customer.

**Credit Insurance:** life and health insurance issued in conjunction with borrowing by individuals; covers payments or unpaid balance when borrower is disabled or dies; in business, covers loss of receivables when debtor becomes insolvent.

**Credit Interchange:** exchange of credit information between individuals or groups.

**Credit Investigation:** inquiry made by a financial institution or trade creditor concerning subject that is not the responding financial institution’s customer.

**Credit Limit:** maximum amount of credit made available to customer by specific creditor.

**Credit Line:** commitment by a financial institution to lend funds to a borrower up to a given amount over a specified future period under certain pre-established conditions. Normally reviewed annually.

**Credit Management:** function of planning, organizing, implementing, and supervising credit policies of a company.

**Credit Sponsor:** individual or entity providing financial support for the property.

**Creditor:** 1. one to whom debt is owed by another as a result of a financial transaction. 2. one who extends credit and to whom money is due.
Creditors’ Committee: voluntary representative group of creditors who may examine affairs of insolvent debtor. Group will usually advise as to continuation of business, study accountant’s and appraiser’s reports, act as watchdog over operating business, advise as to recommendations to appropriate groups or legal body so that creditors will realize largest settlement possible, and advise as to acceptability of settlement.

Creditors’ Remedies: legal rights enabling creditors to collect delinquent debts owed them.

Credit Policy: company’s written procedures for making credit decisions. Used to aid company in meeting its overall risk management objectives. Most financial institutions have a written Credit Policy governing lending activities.

Credit Process Review: assessment of entire credit-granting process concerning specific financial institution loan portfolio(s).

Credit Rating: appraisal made by a financial institution or credit agency as to creditworthiness of a person or company. Such report will include background on owners, estimate of financial strength and ability to pay when due, and company’s payment record.

Credit Record: written history of how well customer has handled debt repayment.

Credit Report: 1. report to aid management in reaching credit, sales, and financial decisions. 2. confidential report containing information obtained by mercantile agency that has investigated background, credit history, financial strength, and payment record of company.

Credit Reporting Agency: company or trade interchange group that confidentially supplies subscribers or members with credit information and other relevant data as to a company’s ability or likelihood to pay for goods and services purchased on credit.

Credit Review: follow-up monitoring of loan or extension of credit by credit review officer or department, senior loan committee, auditor, or regulatory agency intended to determine whether loan was made in accordance with lender’s written credit standards and policies and in compliance with banking regulations. Errors, omissions, concentrations, etc., if detected by credit review process, can then be corrected by lending officers, thus preventing deterioration in credit quality and possible loan losses. Also called loan review.

Credit Risk: 1. evaluation of a customer’s ability or willingness to pay debts on time. 2. risk that a financial institution assumes when it makes any loan to a customer including a irrevocable payment on behalf of its customer against insufficient funds.

Credit Scoring: statistical model used to predict the creditworthiness of credit applicants. Credit scoring estimates repayment probability based on information in credit application and credit bureau report. The two main types of credit scoring are application scoring for new accounts and behavior scoring for accounts that have been activated and are carrying balances.

Credit Terms: stated and agreed on terms for debt repayment.
Credit Union: a member-owned nonprofit cooperative financial organization chartered by a Jurisdictional government to provide financial services such as deposit and loan activities.

Creditworthy: term used to describe individual or entity deemed worthy of extension of credit.

Cross Acceleration: a term or condition in a loan agreement which provides the lender the right to demand loans if the borrower defaults under any other agreement, provided the other lender accelerates repayment of the its loan. The right is generally limited to defaults in agreements over a defined threshold.

Cross Collateralization: Represents a situation that collateral for one loan is also used to secure additional loans.

Cross Default: a term or condition in a loan agreement, which provides the lender the right to demand loans if the borrower defaults under any other agreement. Unlike Cross Acceleration, the other lender need not accelerate its loans in order for us to demand our loans. The right is generally limited to defaults in agreements over a defined threshold.

Cubic Foot Cost: estimated cost of building a structure divided by the calculated number of cubic feet enclosed by the walls, basement floor, and roof. Refer Square Foot Cost.

Current Assets: short-term assets of company, including cash, accounts receivable, temporary investments, and goods and materials in inventory.

Current Liabilities: short-term obligations due within one year, including current maturities of long-term debts.

Current Open Account: sale of goods or services for which customer does not pay for each purchase but rather is required to settle in full periodically or within specified time period after each transaction.

Current Portion of Long Term Debt: for purposes of calculating coverage ratios: 1. in a committed loan, the amount of debt that is repayable over the next 12 months; 2. in a demand loan, the scheduled amortization of principal payments over the next 12 months. Due to a change in GAAP, which became effective January 1, 2004, the entire portion of any loan that is demand will now be classified as current for financial statement purposes.

Current Ratio: total of current assets divided by total current liabilities; used as indication of a company’s liquidity and ability to service current obligations.

Cyclicality: The extent to which an industry is affected by economic or business cycles.

D

D&B: see Dun & Bradstreet, Inc.
**Dating (Terms):** extension of credit terms beyond normal terms because of industry’s seasonality or unusual circumstance.

**Days Sales Outstanding (DSO):** a calculation that expresses the average time in days that receivables are outstanding. Also referred to as Receivables Days on Hand.

**DBA:** see *Doing Business As*.

**DDA:** see *Demand Deposit Account*.

**Dealer Loan:** see *Floor Plan*.

**Debenture:** 1. unsecured, long-term indebtedness or corporate obligation. 2. a security instrument utilized to pledge security on personal and real property. It can be either Fixed, Floating or Fixed and Floating. A floating charge debenture provides a floating charge on all of the borrower’s assets, and a fixed charge typically registers against specific assets, such as real estate.

**Debit:** entry on left side of accounting ledger.

**Debit Card:** magnetized plastic card that permits customers to withdraw cash from automatic teller machines and make purchases with charges deducted from funds on deposit at a predesignated account.

**Debt:** 1. specified amount of money, goods, or services that is owed from one to another, including not only obligation of debtor to pay but also right of creditor to receive and enforce payment. 2. financial obligation of debtor.

**Debt/Equity Ratio:** measure of firm’s leverage position derived by dividing total debts by equity.

**Debtor:** person or entity indebted to or owing money to another.

**Debtor in Possession (DIP):** under the CCAA, a debtor may continue to maintain possession of its assets and use them in normal business operations.

**Debtor-in-Possession Financing:** credit facilities extended to borrower who is reorganizing under Company Creditor Arrangement Act.

**Debt Service:** total interest and scheduled principal payments on debt due within given time frame.

**Debt-Service Coverage (DSC) Ratio:** ratio between the net operating income plus interest, depreciation and net of extraordinary losses or gains available to service interest and principal payments and the amount of those payments. It is an assessment of a concern’s ability to make debt payments from cash flow generated from normal operations.
**Debt Subordination Agreement:** a three party agreement between a borrower, the lender (beneficiary) another lender to the borrower in which the borrower’s second lender is willing to forebear payment from the borrower of principal and, or interest until a future date generally until the satisfaction the lender’s debt who is the beneficiary of the agreement. The other lender may be an individual or business.

**Debt to Tangible Net Worth:** a leverage ratio that compares true owners’ equity investment to assets provided creditors. The ratio: total liabilities over net worth minus intangible assets with the quotient expressed as x:y.

**Decision:** judgment, decree, or verdict pronounced by court in determination of case.

**Declarations Page:** policy form containing data regarding insured, policy term, premium, type and amount of coverage, designation of forms and endorsements incorporated at time policy is issued, name of insurer, and countersignature of agent.

**Deductible:** portion of loss that is not insured; may be stated amount deducted from loss or percentage of loss or of value of property at time of loss.

**Decree:** decision of a court of equity, admiralty, probate, or divorce; to be distinguished from the judgment of a court of law.

**Deduction:** partial amount of payment that is withheld.

**Defalcation:** misappropriation of funds held in trust for another.

**Defamation:** injury to person’s or entity’s character, reputation, or good name by false and malicious statements (includes both libel and slander).

**Default:** to fail to meet obligation or terms of loan agreement such as payment of principal or interest. Refer Event of Default.

**Default Charge:** legally agreed upon charge or penalty added to account when payment of debt is late or another event of default occurs under a loan agreement.

**Defendant:** person or entity defending or denying claim; party against which suit or charge has been filed in court of law. See also *Plaintiff*.

**Defer:** to postpone or delay action.

**Deferred Payment Sale:** selling on installment plan with payments delayed or postponed until future date.

**Deficiency Judgment:** court order authorizing collection from a debtor of any part of a debt that remains unsatisfied after foreclosure and sale of collateral.

**Deficit:** difference between receipts and expenses when expenses are greater.

**Defraud:** to deprive person of property by fraud, deceit, or artifice.
Defunct: business that has ceased to exist and is without assets; concern that has failed.

Delinquent: 1. past-due obligation; overdue and unpaid account. 2. to be in arrears in payment of debts, loans, taxes. 3. to have failed in duty or responsibility.

Demand Deposit Account (DDA): funds on deposit in chequing account that are payable by a financial institution upon demand of depositor. See also Time Deposit.

Demand Draft: written order directing that payment be made, on sight, to third party.

Demand Letter: correspondence sent by creditor, collection agency, or lawyer to debtor requesting payment of obligation by specific date.

Demand Loan: loan with no fixed due date and payable on demand by maker of loan; loan that can be “called” by lender at any time.

Demand Mortgage: mortgage that may be called for payment on demand.

Demurrage: charge that is fixed by contract and payable by recipient of goods for detaining freight car or ship longer than agreed in order to load or unload. Purpose is remuneration to owner of vessel for earnings he or she was improperly caused to lose.

Deposit: 1. amount of money given as down payment for goods or as consideration for contract. 2. funds retained in customer’s bank account.

Depreciation: decline in value of fixed assets, allocating purchase cost of an asset plus additions to value over its useful economic life as outlined by GAAP. See also Obsolescence.

Derivatives: broad family of financial instruments with characteristics of forward or option contracts.

Derogatory Account Information: adverse information on customers who have not paid accounts with other creditors according to payment terms, as reported to a credit bureau.

Deterioration: disintegration or wasting away as a result of wear and tear, exposure to the elements, or other destructive forces.

Development Approach: valuation methodology frequently used to value raw land intended to be developed as a subdivision or to estimate the Value Upon Completion of any type of proposed development where the finished property will be sold to its ultimate end users or owners, e.g., condominium project or time-share property. It is applied by first estimating both the expected gross selling price of the finished units or lots and their expected rate of absorption by the market and then deducting all direct expenses of development, such as the cost of streets, utilities, disposition and holding costs. The deduction for entrepreneurial profit may be handled explicitly, as a line item deduction in arriving at the net cash flow estimate, or implicitly as a part of the discount rate. The resulting net cash flows are discounted to a present-worth estimate by applying a market-derived discount rate, reflecting the cost of both borrowed and equity capital. The present worth of the net cash flows is considered to represent the indicated value of the raw
land. This method is also referred to as the subdivision method or the subdivision analysis method.

**Direct Cash Flow Statement:** a Cash Flow Statement for a specific period generated in a format starting with Sales/Revenues, often referred to as a “Top Down” cash flow statement.

**Direct-Method Cash After Operations:** calculated in a “Direct Cash Flow Statement” it is that amount of cash generated by a concern from its normal operations, before miscellaneous items, taxes and financing costs.

**Direct Reduction Plan:** see [Level Payment Plan](#).

**Directors and Officers Liability Insurance:** legal liability coverage for wrongful acts including breach of duty but not fraud or dishonesty. Often known as E & O, or Errors and Omissions Insurance.

**Disbursement:** full or partial advancement of funds.

**Disbursement Schedule:** list or tabular statement of the amounts to be disbursed at specified dates in accordance with agreements entered into in a mortgage loan transaction.

**Discharge:** 1. cancel or release obligation. 2. release debtor from all or most debts in bankruptcy.

**Disclaimer Opinion of a Financial Statement:** the Auditor does not wish to express an opinion on the financial statements as there is insufficient information to do so.

**Disclaimer Statement:** notice disclaiming responsibility for accuracy, completeness, or timeliness of credit information. Most disclaimer statements also urge recipients of information not to unduly rely on information and stress the confidential nature of information being disclosed.

**Discontinued Operations:** operations of a segment of a company, usually a subsidiary whose activities represent a separate line of business that, although still operating, are subject of formal plan of disposal approved by management.

**Discount:** 1. interest deducted from face amount of note at time loan is made. 2. trade term used for reduction of invoice amount when payment has been made within specified terms.

**Discount Rate:** the rate of interest the Federal Reserve Bank charges member depository institutions for credit.

**Discounted Cash Flow (DCF) Analysis:** appraisal concept whereby the timing and quantity of periodic income and reversion of property value are specified and discounted to a present value at a specified rate.

**Discounted Note:** 1. borrowing arrangement in which interest is deducted from face amount of note before proceeds are advanced. See also [Note](#). 2. term used when customer endorses note received from another party and presents it to a financial institution to obtain funds.
Discounted Value: a misnomer; see *Value to a Single Purchaser*.

Discounting: concept of time preference that holds that future income or benefits are worth less than the same income or benefits received today, and that the value of future income or benefits systematically declines as the time for their receipt is further deferred into the future. In appraisal analysis, discounting is the arithmetic procedure for applying a specified rate derived from the market to the anticipated future income stream in order to develop a present-worth estimate.

Dishonor: to fail to make payment of negotiable instrument on its due date.

Disintermediation: withdrawal of funds from interest-bearing deposit accounts when rates on competing financial instruments, such as money market mutual funds, stocks, and bonds, offer better returns.

Dismissal: court order or judgment disposing action, suit, or motion without trial.

Disposition Costs: all direct costs incurred as a result of the final disposition of an asset, including but not limited to Broker fees and commissions, settlement attorney fees, advertising expenses, title fees, survey fees, deed transfer taxes or stamps, and other miscellaneous fees.

Dispossess: legal action taken by landlord to put individual or business tenant out of his or her property.

Dissolution of Corporation: termination of entity’s existence by law, expiration of charter, loss of all members, or failure to meet statutory level of members.

Distribution: one or more payments made to creditors who have approved claims filed in a bankruptcy proceeding, assignment for the benefit of creditors, or receivership.

Distributor: business engaged in the distribution or marketing of manufacturer’s goods to customers or dealers. See also *Wholesaler*.

Dividend: 1. periodic distribution of cash or property to shareholders of corporation as return on their investment.

Dividend Restriction: a loan agreement covenant in which the borrower agrees to eliminate the payment of dividends or limit payment to a pre-determined dollar amount or percentage of net profit after tax.

Document: any written instrument that records letters with figures or marks that may be used as evidence.

Documentary Evidence: any written record or inanimate object, as distinguished from oral evidence.

Documentary Letter of Credit: Is a conditionally written obligation of the issuing bank on behalf of a purchaser to transfer a fixed amount to the seller upon presentation of certain
documents. The type of documents and presentation period are precisely defined in the letter of credit.

**Documents of Title:** includes bill of lading, dock warrant, dock receipt, warehouse receipt, order for the delivery of goods, and any other document that in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold, and dispose of the document and the goods it covers. To be a document of title, a document must purport to be issued by, or addressed to, a bailee and purport to cover goods in the bailee’s possession that are either identified or are fungible portions of an identified mass.

**Doing Business As (DBA):** reference term placed before trade name under which business operates. Sometimes used as fictitious trade style acknowledging that name is not part of corporation title or registered trademark.

**Domestic Corporation:** company doing business in a Jurisdiction in which it is incorporated.

**Dormant Account:** inactive deposit account in which there have been no deposits or withdrawals for a specified period of time.

**Doubtful Assets:** assets that have all weaknesses inherent in substandard assets with added characteristic that weaknesses make collection or liquidation in full, on basis of currently existing facts, conditions, and values, highly questionable and improbable. Possibility of loss is extremely high. Because of certain important and reasonably specific pending factors that may strengthen assets, classification as estimated loss is deferred until more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral, and refinancing plans.

**Dower:** the right that a spouse has in some Jurisdictions to the real property of the deceased spouse.

**Dower Act:** Regulations in certain Jurisdictions governing the rights of spouses with respect to the matrimonial homestead.

**Downgrading:** 1. lowering of assessment of customer’s creditworthiness. 2. worsening the internally assigned credit quality rating of a loan or relationship in order to appropriately report risk.

**Down Payment:** up-front partial payment made to secure right to purchase goods.

**Downstream Funding:** funds borrowed by holding company for a subsidiary’s use, generally to obtain more favorable rate; contrasts with *Upstream Funding*.

**Draft:** written order by one party (drawer) directing second party (drawee) to pay sum of money to third party (payee). See also *Banker’s Acceptance, Letter of Credit, Sight Draft*, and *Time Draft*.

**Drawee:** person or entity that is expected to pay check or draft when instrument is presented for payment.
**Drawer**: party instructing drawee to pay someone else by writing or drawing check or draft. Also called *maker* or writer.

**Drop Shipment**: shipment of goods delivered directly from manufacturer to customer.

**DSO**: see *Days Sales Outstanding*

**Due Date**: stated maturity date for debt obligation.

**Due Diligence**: with respect to financial institutions: 1. responsibility of an entity’s directors and officers to act in a prudent manner in evaluating credit applications; in essence, using same degree of care that ordinary person would use in making same analysis. 2. review that is made of a loan portfolio of a potential merger candidate by an acquiring institution.

**Due Process of Law**: law in its regular course of administration through courts as guaranteed by the Canadian Constitution and the Bill of Rights.

**Dun & Bradstreet, Inc. (D&B)**: international mercantile agency supplying information and credit ratings on all types of businesses.

**D-U-N-S Number**: (Data Universal Numbering System) code developed by Dun & Bradstreet that identifies specific business name and location.

**Durable Goods**: goods that provide long-lasting qualities and continuing services.

**Duress**: unlawful constraint that forces person to do what he or she would not have done by choice.

**Duty**: 1. legal, moral, or ethical obligation. 2. tax collected on import or export of goods.

**Dwelling Unit**: living quarters occupied, or intended for occupancy, by one household.

**E**

**Earnest Money**: money that one contracting party gives to another at the time of entering into the contract in order to bind the contract in good faith, and which will be forfeited if the purchaser fails to carry out the contract.

**Earnings Report**: income statement showing business’s or individual’s revenues and expenses for stated period of time.

**Easement**: acquired right of use or enjoyment, falling short of ownership, that an owner or possessor of land may have in the land of another, such as a right of way. Public utility companies obtain, or are granted, easements to permit them to construct and maintain poles and lines required for their service.
**EBIT:** a term to describe the measurement of (E) earnings (B) before (I) interest and (T) taxes and represents the numerator in calculating interest coverage ratios with the denominator being interest expense. The purpose is to determine the number of times earnings, not operating cash generation, can cover interest expense.

**EBITDA:** a term to describe the measurement of revenue less costs of goods sold and SG&A expenses and determine profitability (B) before (I) interest, (T) taxes, (D) depreciation and (A) amortization.

**EBITDAR:** (E) earnings (B) before (I) interest, (T) taxes, (D) depreciation, (A) amortization and (R) rent. A concerns earnings before the deduction of interest expenses, taxes, depreciation, amortization, and rent. Similar to, but less common than, EBITDA.

**Economic Feasibility:** ability to recover the cost of an economic activity through future economic benefits directly related to the activity. The economic cost of an activity is the market price of expenditures for land, labor, capital, and entrepreneurial reward, which are incidental to the activity. For an activity to be considered economically feasible the economic costs expended from the commencement of an activity until its conclusion must be equal to or less than the anticipated future economic benefits directly related to the activity. Conversely, when the economic costs expended on an activity from its commencement until its conclusion exceed the anticipated economic rewards, the activity is considered unfeasible. It is frequently measured by comparing the cost of production from the commencement of an activity until a specified date, to the value of the anticipated future benefit flows as of the same date. In the context of real estate projects that are proposed, under construction, or under conversion to a new use, the test for this would be a comparison of the total cost of production to either the prospective market value upon stabilized occupancy or the prospective market value upon completion of construction. When the prospective market value at either of these two points in time is equal to or greater than the cost associated with achieving either stabilized occupancy or completion of construction, the project might be considered to be economically feasible.

**Economic Life (Economic useful life):** A defined period of time that a fixed or intangible asset is expected to provide a positive benefit.

**Economic Order Quantity (EOQ):** The amount of orders that minimizes total variable costs required to order and hold inventory.

**Effective Gross Income (EGI):** potential gross income from an income-producing property less an actual or estimated vacancy and/or credit losses created by uncollectable rent.

**Effective Rent:** rent to be received stated in economic terms. How much value is truly being received by the landlord? Calculating the effective rent involves adjusting the contract rent for any concessions given up by the landlord in securing the tenant. This is the most important rent measure to focus on and compare to expectations.

**Effective Tax Rate:** actual income tax paid divided by net taxable income before taxes, expressed as a percentage.

**Egress:** ability to exit a property.
EFT: see *Electronic Funds Transfer*

**Electronic Funds Transfer (EFT):** computerized system enabling funds to be debited, credited, or transferred between financial institution accounts and vendors.

**Eligibility:** a term used to describe assets that are deemed acceptable as potential collateral in secured or formula based working capital finance transactions.

**Eligible Inventory:** inventory that is deemed acceptable as potential collateral in secured or formula based working capital finance.

**Eligible Accounts Receivable:** accounts receivable that are deemed acceptable as potential collateral in secured or formula based working capital finance.

**Embezzlement:** fraudulent appropriation of one’s property by person to whom it was entrusted.

**Eminent Domain:** inherent right of a sovereign power to appropriate all or any part of the private property within its borders for a necessary public use, with or without the consent of the owner or owners, by making reasonable compensation.

**Employee Stock Ownership Plan-US/Employee Shared Ownership Plan - Canada (ESOP):** An ESOP is a specific employee benefit or retirement plan, similar in some ways to a profit-sharing plan. In an ESOP, a company establishes a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. The ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Generally company contributions to the trust are tax-deductible.

**Encroachment:** occupancy of the land of another by the extension of a building or other improvement beyond the lot line.

**Encumbrance:** lien or claim against title to property that, unless removed, prevents the passing of full and complete title. See also *Unencumbered Property*.

**Endorsement:** 1. act of writing one’s name on back of note, bill, cheque, or similar written instrument for payment of money; required on negotiable instrument to pass title properly to another. By signing such instrument endorser becomes party to it and thereby liable, under certain conditions, for its payment. 2. change or addition to insurance policy, informally called a *rider*.

**Engagement Letter:** letter by which an auditor, appraiser, consultant or other professional is formally engaged to perform and report on specific functions. It sets forth the specifications of the scope of the assignment and is used to transmit information needed by the professional to properly complete the function.

**Entitlements:** total of necessary municipal or other approvals and permits required before a development can begin.

**Entrepreneur:** person who plans, organizes, and runs operation of new business.
Entrepreneurial Profit: profit factor built into a cash flow valuation to account for an appropriate return to the owner/developer based upon the type of property and risk involved.

Environmental Survey: a professional survey prepared for a lender for the purpose of ascertaining whether there are environmental risks associated with commercial real estate that the lender will hold as collateral. The purpose of the survey is to mitigate potential claims that could be brought to the lender for environmental clean up when a mortgagee is unable to remedy.

EOM Terms: shipments during a month are invoiced in a single statement dated as of the last day of that month or the first day of the following month.

EOQ: Economic Order Quantity

Equity: 1. interest of an ownership nature, as distinguished from an interest of a creditor nature. 2. value of collateral over and above the amount of the obligation it secures. 3. system of legal principles and rules developed to supplement and correct a system of law that had become too narrow and rigid in scope and application. Its characteristic is flexibility and its aim is the administration of justice.

Equity of Redemption: right of an owner of a mortgaged or encumbered property to recover the rights transferred by the mortgage or other lien, on satisfaction of the debt either before or after foreclosure.

Escheat: right of state to claim property or money if there is no legal claim made to it.

Escrow: written agreement or instrument setting up the allocation of funds or securities deposited by the giver or grantor to a third party, called the escrow agent, for the eventual benefit of the second party, called the grantee. The escrow agent holds the deposit until certain conditions have been met. The grantor cannot get the deposit back except if the grantee fails to comply with the terms of the contract, nor can the grantee receive the deposit until the conditions have been met.

Escrow Account: liability account in the books of the escrow agent. All funds that are deposited as escrow by the mortgagor are posted to this account. When the funds are to be disbursed by the agreement, this account is debited, and the disbursement is the credit. Escrow accounts usually have a preferred status in trust companies.

Estate: any right, title, or interest that person may have in lands or other personal property.

Estimate: amount of labor, materials, and other costs a contractor anticipates for project, as summarized in contractor’s bid proposal for project.

Estoppel Certificate: statement of material facts or conditions conveyed to a third party. Often submitted to a lender in support of the facts of a lease.
**Event of Default:** breach of an agreement between parties to a contract; a violation of one or more of the loan covenants as set forth in either the loan agreement, commitment letter, or promissory note.

**Evergreen Revolving Credit:** commitment to lend money that remains in effect unless lender takes specific action to terminate agreement; agreement may provide that in event of termination, any outstanding amount will convert to term loan.

**Evidence of Indebtedness:** an inclusion in a loan agreement, which negates the requirement for the Borrower to execute a promissory note.

**Excess Cash Flow Recapture Provision:** a non standard type of loan document condition that a borrower agrees to make special principal payments after a certain level of cash flow is generated. Generally the calculation is based upon some amount in excess of a defined threshold such as EBITDA or Net Cash Income. The recapture payment is usually paid on an annual basis. Also known as a cash sweep.

**Exchange Rate:** value of one country’s currency to that of another country at a particular point in time.

**Exclusive Sales Agreement:** contractual arrangement, generally between a retailer and a manufacturer or wholesaler, giving retailer exclusive rights for sale of articles or services within a defined geographic area or by a defined distribution channel.

**Exculpation:** Formal excusing of a party from a liability on debt.

**Execute:** to complete and give validity to a legal document by signing, sealing, and delivering it.

**Executor:** individual or a trust institution named in a will and appointed by a court to settle the estate of the decedent.

**Exempt:** 1. to release, discharge, or waive from a liability to which others in same general class are subject. 2. property not available for seizure.

**Exemption:** 1. immunity from general burden, tax, or charge. 2. legal right of debtor to hold portion of property free from claims or judgments.

**Expense:** cost or outlay of money used in business operating cycle.

**Expense Stop:** amount, typically expressed in dollars per square foot, of an income-producing property over which the tenant agrees to pay expenses.

**Expertise Sponsor:** individual or entity providing the expertise required to complete, market, and manage the property.

**Export Development Canada (EDC):** provides financing, insurance and bonding services for Canadian exporters and investors. EDC does not compete with commercial lenders, but assumes the risks they cannot accept.
Expropriation: The official seizure by a government of private property. Any government has the right to seize such property, according to international law, if prompt and adequate compensation is given.

**Face Amount:** indicated value of a financial instrument, as shown on its front.

**Facility Fee:** lender’s charge for making line of credit or other credit facility available to borrower (for example, commitment fee).

**Facsimile:** exact copy of an original.

**Factor:** entity that purchases borrower’s accounts receivable and may extend funds to borrower prior to collection of receivables.

**Factoring:** short-term financing from nonrecourse sale of accounts receivable to third party or factor. Factor assumes full risk of collection, including credit losses. There are two basic types of factoring:
- discount factoring, in which factor pays discounted price for receivables before maturity date.
- maturity factoring, in which factor pays client purchase price of factored accounts at maturity.

**Fair Market Value:** price that property would sell for between willing buyer and willing seller, neither of whom is obligated to effect transaction.

**Federal Tax Lien:** an encumbrance upon certain business or personal assets as a result of Federal tax liability default. Is generally unsecured and does not have priority in bankruptcy.

**Fee Simple:** estate in which owner is entitled to entire property and has unconditional power over its disposition. **Fictitious Name:** pretend name used by firm in business transactions. Company is usually required to register this name with local authorities, along with true names and addresses of company’s owners.

**Fidelity Bond:** contract issued by insurer to employer to cover loss caused by dishonest acts of employees; form of suretyship. Also called dishonesty insurance.

**Fiduciary:** individual or a trust institution charged with the duty of acting for the benefit of another party in a confidential capacity. The guardian and ward, an agent and principal, an attorney and client, one partner and another partner, a trustee and a beneficiary—all are fiduciary relationships.

**Field Audit (Field Examination):** the term has broad based implications covering numerous lending products although it generally is most often associated with asset based lending. The purpose of the audit is to provide a comprehensive review and gain an understanding of the
borrower and its operations, determine collateral values, assess accounting system adequacy, and identify other potential credit or operational risks.

**Field Warehousing:** method of using company’s inventory to secure a business loan. In a leased and separate storage area of borrower’s facility, goods act as security for loan and are released by custodian only upon lender’s order.

**FIFO:** see *First-In First-Out*.

**File:** 1. organized folder containing accumulation of information and items retained for preservation or reference. 2. to deposit legal document with proper authority.

**File Revision:** routine gathering of credit information by credit grantor to update files on borrowers.

**Filing Claims:** 1. depositing of formal papers with proper public office and in manner and time frame prescribed by law in order to preserve creditor’s rights. 2. method used to perfect security interest accomplished by recording in proper public office.

**Finance Charges:** total costs to an individual or business of obtaining credit, including interest and any fees.

**Financial Analysis:** evaluation by credit analyst of customer’s financial situation to determine whether customer has ability to meet his or her obligations as they become due. Factors such as general condition of customer’s industry, organizational structure, available collateral or guarantors, and past financial performance are considered.

**Financial Institution:** defined in Office of the Superintendent of Financial Institutions Act as a bank or foreign bank as defined under the Bank Act, a company to which the Trust and Loan Companies Act applies, an association to which the Cooperative Credit Associations Act applies, a company, society, foreign company or provincial company to which the Insurance Companies Act applies and Green Shield Canada.

**Financial Leverage:** the level to which a business or individual is utilizing borrowed money. Financial leverage can also be used to describe the impact on earnings attributed to the extent to which the firm’s assets are financed with borrowed money.

**Financial Position:** standing of company, combining assets and liabilities as entered on balance sheet.

**Financial Statements:** reports consisting of individual’s or company’s balance sheet, income statement, and statement of cash flows, footnotes, and any supplemental schedules.

**Financing Statement:** form required to be completed by creditor and filed with appropriate Jurisdictional authorities in order to perfect creditor’s security interest in collateral and to give public notice of such interest.
**Financing Surplus or Requirement**: A term associated with UCA-Direct cash flow statements and represent the cash position of a company after considering all Operating and Investing activities. Surplus indicates a positive cash position and Requirement indicates a negative cash position.

**First-In First-Out (FIFO)**: method of valuing inventory in which the first goods received are the first goods used or sold. Using this method, costs of inventory used to determine cost of goods sold are related to costs that were incurred first.

**First Charge**: a term that identifies the priority claim established by the lender on specific collateral whether chattel, intangible or real estate to secure outstanding debt. A synonym phrase would be first position perfected security interest.

**First Mortgage**: legal instrument that creates or conveys a lien on or a claim against an owner’s rights in property prior to a lien created by any other mortgage. See also Junior Mortgage.

**Fiscal**: anything involving financial matters or issues.

**Fiscal Agent**: person or organization serving as another’s financial agent or representative.

**Fiscal Year**: fixed accounting year used as basis for annual financial reporting by business or government.

**Five C’s of Credit**: method of evaluating potential borrower’s creditworthiness based on five criteria: Capacity, Capital, Character, Collateral, and Conditions.

**Fixed Assets**: property used in normal course of business that is of long-term nature, such as land, machinery, fixtures, and equipment.

**Fixed Charge Coverage Ratio (FCCR)**: profits before income taxes and interest payments divided by long-term interest for a period. An assessment of a concern’s ability to generate sufficient cash to cover fixed charges.

**Fixed Charges**: 1. any financial expense that is predetermined and mandatory is considered a fixed charge, usually interest but may include certain principal payments. In calculating fixed charge coverage ratio the fixed charge base (denominator) is interest, lease and rental expense, plus CPLTD. 2. A security position that attaches to a specific piece of security, such as a fixed charge on a specified piece of real estate.

**Fixed-Rate Loan**: loan with interest rate that does not vary over term of loan.

**Fixture**: that which is permanently attached or affixed to real property.

**Fixture Filing**: a common term used under PPSA to describe the notice that must be registered at Land Titles in order to perfect a lender’s interest in personal property that may become a fixture (for example a mobile home).
Flagging an Account: temporarily identifying account for specific purpose or reason; may involve suspending activity.

Float: uncollected funds represented by cheques deposited in one bank but not yet cleared through bank on which they are drawn.

Floating Interest Rate: loan interest rate that changes whenever the stated index rate, or base rate, changes.

Floating Charge: loan or credit facility secured by all assets of the borrower identified in the security document. Under PPSA, it could be a floating charge on all of the borrowers “present and after acquired personal property”. This type of security agreement gives lender interest in assets acquired by borrower after agreement, as well as those owned when agreement was made. When agreement covers proceeds from sales, lender also has recourse against cash collected from the payment of receivables.

Floor Plan: loan made to dealer for purchase of inventory acquired for resale and secured by that inventory, such as automobiles or appliances.

Floor Plan Arrangement (Floor Plan Line, Wholesale Finance): A form of working capital finance that provides for the financing of inventory and supplants or supplements vendor accounts payable. Generally it is provided by a third party lender who may have an agreement called a repurchase agreement with the manufacturer or supplier that allows the lender to return inventory in the event of borrower default.

FOB: see Free on Board.

FOB Point: point at which responsibility for freight charges begins and title passes. See also Free on Board.

Forbearance: temporarily giving up the right to enforce a valid claim, in return for a promise. It is sufficient consideration to make a promise binding (for example, protracted payment arrangements or interest rate reduction in exchange for additional collateral or guarantors).

Forced Sale: 1. court-ordered sale of property, usually without owner’s approval. 2. voluntary sale of goods or property to raise cash or to reduce inventory.

Foreclosure: legal process by which a mortgagor of real or personal property, or other owner of property subject to a lien, is deprived of his or her interest therein. The usual modern method is sale of the property by court proceedings or outside of court.

Foreign Corporation: corporation established under laws of a Jurisdiction other than the Jurisdiction in which it is doing business.

Foreign Exchange: conversion of money of one country into its equivalent in currency of another country.
**Foreign Exchange Hedging Contract:** a contract that allows for the purchase or sale of a foreign currency at a predetermined rate of exchange as a defense against rate fluctuations.

**Foreign Item:** check drawn on any financial institution other than the financial institution where it is presented for payment. Also called transit item.

**Foreign Judgment:** judgment obtained in a Jurisdiction or country other than the one where debtor now lives, is doing business, or has assets.

**Forfeiture:** penalty resulting in automatic loss of cash, property, or rights for not complying with legal terms of agreement.

**Forgery:** falsifying or materially altering a document with intent to defraud.

**Form 8K:** report disclosing significant events potentially affecting corporation’s financial condition or market value of its shares, required by Securities and Exchange Commission. Report is filed within 30 days after event (pending merger, amendment to corporate charter, charge to earnings for credit losses) took place and summarizes information that any reasonable investor would want to know before buying or selling securities.

**Form 10K:** annual financial report filed with Securities and Exchange Commission. Issuers of registered securities are required to file 10K, as well as corporations with 500 or more shareholders or assets of $2 million and exchange-listed corporations. Report, which becomes public information once filed, summarizes key financial information, including sources and uses of funds by type of business, net pretax operating income, provision for income taxes and credit losses, plus comparative financial statements for past two fiscal years. Summary of 10K report is included in annual report to stockholders.

**Form 10Q:** quarterly financial report filed by companies with listed securities and corporations required to file annual 10K report with Securities and Exchange Commission. 10Q report, which does not have to be audited, summarizes key financial data on earnings and expenses and compares current financial information with data reported in same quarter of previous year.

**Foreseeable Future:** time period during which the probability of a future event or series of events happening can be forecast with a reasonable degree of reliability. A reasonably manageable future time period. A forecast is based upon data that are known or knowable at the time it is prepared. A time period (foreseeable future) is therefore the period in which there is a reasonable degree of certainty that the forecasted future events will occur.

**Franchise:** business agreement whereby one company allows another the right to conduct business under its name and/or distribute its products in exchange for royalties or another agreed upon method of payment.

**Fraud:** any act of deceit, omission, or commission used to deprive someone of right or property. Elements of fraud consist of intentional misrepresentation of fact, relied on by another to his or her detriment, that results in damages.
Fraudulent Conveyance: transfer of property by a debtor, for the intent and purpose of defrauding his creditors. Such property may be reached by the creditors through appropriate legal proceedings.

Free and Clear: 1. property with an unencumbered title. 2. title that is free of defects.

Free and Clear Delivery Receipt: delivery receipt signed by consignee completely absolving carrier from any claim for loss or damages.

Free Astray: freight shipment that has been lost. If it is carrier’s fault and shipment is located, it is obligation of carrier to make delivery to original destination at no additional cost to shipper or consignee.

Free on Board (FOB): term identifying shipping point from which buyer assumes all responsibilities and costs for transportation.

Free Port: place where goods are imported or exported free of any duty.

Freehold Estate: legal estate in land commonly referred to as an estate of inheritance. The two most important freehold estates are the fee simple estate and the life estate. See also Chattel.

Freight Forwarder: business that receives goods for transportation; services include consolidation of small freight shipments of less than carload, truckload, or container lots assembled for lower shipping rates.

Friable: term applied in environmental reports to asbestos contamination that is easily crumbled.

Frozen Account: 1. account to which customer no longer has access. 2. account suspended by court order, violation of loan covenants, or checking account agreement, etc.

Frozen Assets: any assets that cannot be used by owner because of pending legal action.

Full Service Lease: lease requiring the landlord or lessor to pay all expenses; also known as a Gross Lease.

Fund: cash or equivalents set aside for specific purpose.

Fund Accounting: fiscal and accounting entity with self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for purpose of carrying on specific activities or obtaining certain objectives in accordance with special regulations, restrictions, or limitations.

Fund Conversion Program: plan for maintaining a proper ratio between cash or primary reserves, secondary reserves, and investments.
**Funded Debt:** mortgages, bonds, debentures, notes, or other obligations with maturity of more than one year from statement date.

**GAAP:** see *Generally Accepted Accounting Principles*.

**Garnishee:** 1. person or entity that has possession of money or property belonging to defendant and is served with writ of garnishment to hold money or property for payment of defendant’s debt to plaintiff. 2. one against whom garnishment has been served.

**Garnishment:** legal warning or procedure to one in possession of another’s property not to allow owner access to such property as it will be used to satisfy judgment against owner.

**General Contractor:** contractor who enters into a contract with an owner for construction of a project and who takes full responsibility for its completion. Contractor may enter into subcontracts with various subcontractors for performance of specific parts or phases of project.

**General Ledger:** bookkeeping record comprising all assets, liabilities, proprietorship, revenue, and expense accounts. Entries for each account are posted, and balances are included for each entry.

**Generally Accepted Accounting Principles (GAAP):** conventions, rules, and procedures that define accepted accounting practices, including broad guidelines as well as detailed procedures. Canadian Accounting Standards Board, an independent self-regulatory organization, is responsible for promulgating these principles.

**General Partner:** participant in a business relationship that is personally liable, without limitation, for all partnership debts.

**General Security Agreement:** the underlying document that creates a pledge of collateral by a borrower in support of a loan agreement for personal property referred to as “all present and after acquired personal property”.

**Go-Dark Clause:** act of closing a retail store and vacating, whereby the lease allows a tenant to shut down ("go dark"), but continue to pay rent. If this is an anchor tenant, it could affect the income stream and continuance of other leases in the property.

**Going Concern:** assumes that a business entity has a reasonable expectation of continuing in business and generating a profit for an indefinite period of time.

**Goods on Approval:** goods offered by seller to buyer with option of examining goods for specific period of time before deciding to purchase them.
**Goodwill:** 1. intangible assets of business consisting of its good reputation, valuable clientele, or desirable location that results in above-normal earning power. 2. value or amount for which business could be sold above book value of its physical property and receivables.

**Grace Period:** specified length of time beyond payment due date during which late fee will not be assessed.

**Grantee:** person to whom title in property is made.

**Grantor:** person who transfers property by deed or grants property rights by means of a trust instrument or some other document. The person to whom the property is transferred is called the grantee.

**Green Shield Canada:** a group and individual health and dental benefits organization which is defined as a financial institution to be regulated by OSFI.

**Gross Income, Effective:** estimated gross income from property less allowance for vacancies, uncollectible rents, etc.

**Gross Income, Estimated:** total anticipated earnings from property without deduction for vacancies, uncollectible rents, etc.

**Gross Income Multiplier:** figure by which effective gross income is multiplied to obtain an amount that indicates the capital value of property.

**Gross Margin:** gross profit as a percentage of sales.

**Gross Profit:** net sales less cost of sales.

**Gross Sales:** sales before returns and allowances; discounts are deducted to arrive at **Net Sales**.

**Gross Selling Price:** expected total purchase price exchanged by a single purchaser or group of purchasers for an interest in an identified parcel of real estate. While this normally contemplates a specific transaction date, it frequently is used to identify the gross amount of consideration paid in a series of transactions over time, e.g., as in the sale of condominium units or subdivision lots over time.

**Gross Yield:** return obtained from an investment before deduction of costs and losses involved in procuring and managing the investment. See also **Net Yield**.

**Ground Lease:** lease that grants the right to use and occupy land.

**Ground Rent:** price paid each year or for a term of years for the right to occupy and improve a piece of land.

**Guarantor:** person who agrees by execution of a contract to repay the debt of another if that person defaults.
**Guarantee:** separate agreement by which a party (or parties) other than debtor assumes responsibility for payment of obligation if principal debtor defaults or is subsequently unable to perform under the terms of the obligation.

**Guarantee and Postponement of Claim:** separate agreement by which a party (or parties) other than debtor assumes responsibility for payment of the obligation if principal debtor defaults or is subsequently unable to perform under the terms of the obligation. The Postponement further commits the guarantor not to withdraw money owing to it by the company. If the party signing the Postponement is owed money by the company, or is expected to, it is necessary to register a financing statement on the postponement in order to have a perfected security interest.

**Guarantee Policy:** contract in which one party, the guarantor, agrees to indemnify or protect another party against loss because of certain specified hazards.

**Guaranteed Investment Certificates:** a deposit instrument requiring a minimum investment at a pre-determined rate for a stated period of time.

**Guardian:** person who is legally responsible for the care and management of a minor or individual who is not mentally or legally competent (or of such person’s property).

**H**

**Hard Costs:** costs generally associated with land, labor, improvements, and other physical material used in construction.

**Hard Goods:** durable consumer goods, usually including such items as major appliances and furniture, with relatively long, useful lives.

**Hazard Insurance Contract:** contract between an insurance company and the insured by which, for a designated premium, the insurance company agrees to compensate the insured for loss caused by specified hazards.

**Heavy Industry:** industry involved in manufacturing basic products such as metals, machinery, or other equipment.

**Held Jointly or Joint Tenancy:** relates to the ownership of property by two or more individuals or entities in which ownership immediately passes to the surviving co-joint tenant(s) upon the death of the decedent co-joint tenant.

**Hidden Assets:** assets not easily identified and either intentionally not disclosed or publicly reported at lower value than their true worth.

**High Credit:** largest amount of credit used by borrower during specified period of time.

**Highest and Best Use:** appraisal terminology describing the maximum value attributable to a real property based upon what is physically possible, legally permissible, financially feasible, and maximally productive.
Holdback: A contractual or legal condition which allows money owing to be withheld until a specified event occurs or a specified period of time elapses.

Holder in Due Course: person who has taken negotiable instrument (check or note) for value, in good faith, and on assurance that it is complete and regular, not overdue or dishonored, and has no defect in ownership on part of previous holder or endorser.

Holding Company: company organized to hold and control stock in other companies.

Holding Costs: real estate taxes, insurance, maintenance and repairs, management, and other direct costs expended during the period of time when an asset is held.

Holding Period: as used by an appraiser, it is the expected term of ownership of an investment. It extends from either the date when an investment in real estate is expected to occur or from the present date, if the ownership position currently exists, until the date when the investment and ownership position would normally be terminated through disposition by a long-term investor.

Homestead: property representing the principal grounds or dwelling owned by the head of a household which are specifically defined under Matrimonial Property Acts. Some Jurisdictions provide exemptions of homesteads from seizure by creditors.

Housing Expenses: total of all items of expenditure incurred in connection with the occupancy of housing facilities, except expenses attributable to furniture and furnishings or to capital charges.

Hypothecate: to pledge or assign property owned by one entity as security or collateral for loan to second entity.

Hypothecation: 1. offer of stocks, bonds, or other assets owned by party other than borrower as collateral for loan, without transferring title. Borrower retains possession but gives lender right to sell property in event of default by borrower. 2. pledging of negotiable securities to collateralize broker’s margin loan. If broker pledges same securities to bank as collateral for broker’s loan, process is referred to as re-hypothecation.

Immunity: condition of being exempt from duty that others are generally required to perform.

Impaired Loan: as regulated by OSFI, and consistent with Section 3025 of the CICA Handbook on Impaired Loans. An impaired loan is one in which the ultimate collectibility of the principal and interest is in doubt and OSFI defines what constitutes an impaired loan and how it should be managed. Once a loan is classified as impaired, interest income is no longer recognized, and the principal amount owing must be written down to what is deemed to be collectible.

Import Letter of Credit: commercial letter of credit issued to finance import of goods.
**Import Duty:** government tax on imported items.

**Impound:** to seize or take into legal custody, usually at order of court. Cash, documents, or records may be impounded.

**Inactive Account:** account that has shown little or no activity over a substantial period of time.

**Inactive Files:** 1. accounts on which collection activity has been completed or suspended (claims either collected or found to be uncollectible) and on which no further work is being done. Also called closed or dead files. 2. stored records available for reference.

**In Arrears:** amounts due but not yet paid.

**Income Approach:** appraisal methodology based upon a property’s ability to generate income.

**Income Capitalization:** appraisal methodology whereby a value estimate is derived from dividing the NOI, or income of the property, by the cap rate. Discounted cash flow may also be used with a reversion value estimated at the end of the holding period.

**Income Property:** real property acquired as investment and managed for profit.

**Income Statement:** summary of revenue and expenses covering a specified period.

**Income Tax:** tax levied by Jurisdictional or local governments on personal or business earnings.

**Incorporation:** formation of legal entity, with qualities of perpetual existence and succession.

**Incumbrance:** see *Encumbrance*.

**Indebtedness:** total amount of money or liabilities owed.

**In Default:** failing to abide by terms and conditions of note or loan agreement. This can include, but is not limited to, payments on interest or principal (or both) being past due.

**Indemnity:** 1. contract or assurance to reimburse another against anticipated loss, damage, or failure to fulfill obligation. 2. type of insurance that provides coverage for losses of this nature.

**Indemnity Agreement:** a contract provision that one party will hold harmless or reimburse another party for losses the other party may incur. As example: Company A sells its operating subsidiary, Company B to Company C. As part of the buy/sell agreement Company A agrees to indemnify or hold harmless Company C for any product liability claims for products produced prior to the purchase date.

**Indirect Cash Flow Statement:** A Cash Flow Statement for a specific concern covering a specific period generated in a format starting with Net Income, often referred to as a “Bottom Up” cash flow statement.

**Indirect Liability:** contingent liability such as a continuing guarantee.

Individual Signature: credit approved by one person on his or her own authority.

Indorsement: see Endorsement.

Industrial Consumer: purchaser who buys goods or services for business purposes.

Inquiry: request for credit information on bank’s customer.

Ingress: means of entering a property.

Insolvency: 1. inability to meet debts as they become due in ordinary course of business. 2. financial condition in which assets are not sufficient to satisfy liabilities.

Installment Sale: contract sale in which merchandise is purchased with down payment and balance is made in partial payments over agreed period of time.

Institutional Quality Property: financed property that meets the investment criteria of institutional investors such as insurance companies and pension funds.

Instrument: written document that gives formal expression to a legal act or agreement.

Insufficient Funds: see Non-Sufficient Funds.

Insurable Interest: interest such that loss or damage inflicts economic loss.

Insurable Value: maximum possible loss to which property is exposed; actual amount depends on basis of calculation per insurance policy.

Insurance Companies Act: federal legislation regulating insurance companies and fraternal benefit societies as defined therein.

Intangible Assets: nonmaterial assets of business that have no value in themselves but that represent value. Examples include trademarks, goodwill, patents, and copyrights. Can also include deferred items such as development or organizational expenses.

Interchange: confidential exchange of credit information between individuals and trade groups.

Inter-creditor Agreement: document used when there is more than one lender involved in credit transaction to spell out each lender’s rights and obligations.

Interest: 1. legally allowed or agreed upon compensation to lender for use of borrowed money. 2. any right in property but less than title to it.

Interest Act: federal legislation outlining requirements for interest disclosure in Canada. The act stipulates that if interest is charged on a basis that is other than annual, the lending institution
must disclose what the rate would be if charged annually. Failure to disclose the annual rate can result in the interest being limited to 5%.

**Interest Bearing:** term describing note or contract calling for payment of agreed interest.

**Interest Capitalization:** under CICA guidelines interest may be capitalized and therefore converted from an operating expense to a part of the historical cost for any fixed asset that may require a length of time to be put into use from the date of purchase. The interest on all borrowings or other obligations directly related to the purchase or development of the asset is eligible for capitalization, if it is otherwise considered a material amount. Capitalized interest should be included as part of total interest for calculation of Coverage Ratios.

**Interest Only:** loan term during which no principal repayments are made.

**Interest Rate:** cost of borrowing money expressed as an annualized percentage of the loan.

**Interest Rate Swaps:** is a binding agreement between two parties (counterparties) to exchange something of financial value for something else that has financial value, therefore the two “legs” of the swap. Generally interest rate swaps are single currency and involve a fixed rate leg and a floating rate leg. The swap takes place periodically at predetermined intervals at which time the parties exchange payments.

**Internal Guidance Line of Credit:** credit facility similar to a line of credit, but customer may or may not be advised of it; established for internal financial institution purposes, it provides financing for recurrent requests without referring each one to credit committee or other approval source.

**Internal Rate of Return:** annualized rate of return on capital that is generated or is capable of being generated by an investment during the period of ownership. It is that rate that mathematically equates the expected future cash flows or receipts from an investment with either their present value or initial cost.

**Interest Reserve:** line item within a construction cost breakdown to pay periodic interest, generally on a monthly basis.

**International Consumer Credit Association:** professional trade association of retail credit professionals. Association keeps members informed of latest developments in consumer credit and provides educational courses, seminars, textbooks, and other published material.

**Intestate:** dying without leaving valid will or any other specific instructions as to disposition of property.

**Inventory:** current assets of business that represent goods for sale, including raw materials, work in process, and finished goods.

**Inventory Days:** an Asset Management ratio that establishes the average length of time measured in days from the time inventory is purchased until it is sold, and thus how long a
company has an investment in inventory. Ratio: Inventory times 365 days over Cost of Goods Sold with the quotient expressed as number of days.

**Inventory Reliance Ratio:** a Working Capital type ratio that can be used when the Quick ratio is less than 1:1. The quotient will indicate should all quick assets be converted to cash, what percent of inventory must be converted to cash to cover the remaining amount of current liabilities. Formula: Current Liabilities minus Quick Assets over Inventory with the quotient expressed as a percentage of inventory.

**Inventory Turn:** an Asset Management ratio to measure how many times inventory will turn over on an annual basis. Formula: COGS over average inventory with the quotient expressed as the number of turns per year.

**Investigation:** 1. gathering of credit information on a person or entity. 2. systematic research for information necessary for a business decision.

**Investment:** use of money for purpose of earning profit or return.

**Investment Dealers Association of Canada:** a national organization that self-regulates organizations and representatives of the Canadian securities industry.

**Investment Grade Corporate Bonds:** a corporate bond issued a rating by one of the ratings agencies that indicates the issuer is highly creditworthy with minimal risk of repayment.

**Investor:** person or entity that puts money to use for capital appreciation or profit or to receive regular dividends.

**Invoice:** seller’s descriptive, itemized billing for goods or services sold, showing date, terms, cost, purchase order number, method of shipment, and other identifying information.

**Involuntary Bankruptcy:** see *Bankruptcy*.

**Itemized Statement:** detailed listing of activity on account for particular period of time.

**J**

**Jobber:** see *Wholesaler*.

**Joint Account:** financial institution account shared or owned in name of two or more persons with full privileges available to each person.

**Joint and Several:** relative to liability, a term used when creditor has option of pursuing one or more signers of an agreement individually or all signers together.

**Joint Tenancy with Rights of Survivorship:** interest in property held by two or more persons that includes right of survivorship in which deceased person’s interest passes to survivors. See also *Tenancy by Entirety*. 
Joint Venture: business or undertaking entered into on one-time basis by two or more parties in which profits, losses, and control are shared.

Journal: account book of original entry in which all money receipts and expenses are chronologically recorded.

Judgment: 1. decision or sentence of a court of law; to be distinguished from a decree. 2. obligation created by such a decision or sentence.

Judgment Creditor: one who has obtained judgment against debtor and can enforce it.

Judgment Debtor: one against whom judgment has been recovered but not satisfied.

Judgment Lien: claim or encumbrance on property, allowed by law, usually against real estate of judgment debtor.

Judgment-Proof: term to describe judgment debtor from whom collection cannot be obtained or person who has no money or assets or has concealed or removed property subject to execution.

Judicial Sale: see Forced Sale.

Junior Mortgage: claim against or a lien on the title to a property that is subordinate to that created by a prior mortgage. See also First Mortgage.

Jurisdiction: 1. legal authority, power, capacity, and right of court to act. 2. geographic area within which court or government agency exercises power. The capitalized term in this document refers to the 14 jurisdictions in Canada or any one of them: Federal Government of Canada, Province of British Columbia, Province of Alberta, Province of Saskatchewan, Province of Manitoba, Province of Ontario, Province of Quebec, Province of Nova Scotia, Province of New Brunswick, Province of Prince Edward Island, Province of Newfoundland and Labrador as well as the three territories of Nunavut, Northwest Territories and the Yukon.

Justified Price: price an informed and prudent purchaser would be warranted in paying.

K

Keyperson Life Insurance: insurance policy written on owner or principal employee in which death benefits are payable to company.

Key Ratios: performance measures used to determine probable ability of business to operate profitably. Results are expressed in percentages that are then weighed against average percentages in each industry.

L
**Land Survey:** an independent depiction of the meets and bounds of a tract of land to ensure the identity of the property.

**Landlord’s Waiver:** the relinquishment of a right(s) contained in a lease agreement by a lessor.

**Last-In First-Out (LIFO):** method of evaluating inventory, in which last goods received are the first ones sold. Using this method, inventory costs used to determine cost of goods sold are related to costs of inventory that were incurred last.

**Late Charge:** special fee demanded in connection with any payment on a mortgage loan or other obligation that is not made when due.

**Lawful Money:** legal tender for payment of all debts.

**Law List:** compiled publication of names and addresses of those in legal profession, often including court calendars, private investigators, and other information of interest to legal profession.

**Lawsuit:** suit, action, or cause instituted by one person against another in a court of law.

**Lead Bank:** financial institution that has the primary deposit or lending relationship in a multi-bank situation; usually in the context of shared credit and sometimes defined within an inter-creditor agreement. See also *Agent Bank*.

**Lease:** contract by which an owner of property (lessor) grants to another party (lessee) the right of use, tenancy, or occupancy of that property. The property may be land, buildings, equipment, or other chattel property. The lease agreement describes the rights of the owner and of the renter and recites the terms of periodic payment and the tenure of the lease. The property leased reverts to the owner at the expiration of the lease agreement.

**Leaseback:** agreement by which one party sells property to another, and after completing sale, the first party rents it from second party.

**Lease Contract:** written agreement for which equipment or facilities can be obtained on rental payment basis for specified period of time.

**Leased Department:** section of department store not operated by store but by independent outside organization on contract or percentage-of-sales arrangement.

**Leased Fee Interest:** ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others.

**Leasehold:** an estate or right in real property limited to a definitely ascertainable period of time, obtained and held with the consent of the owner of the estate or right, and on the payment of a stipulated consideration.

**Leasehold Improvement:** permanent improvements made to rented property. Leasehold improvements are considered fixtures and depreciate over lease period.
**Leasehold Interest:** lessee’s equity or ownership in leasehold improvements.

**Lease-Purchase Agreement:** contract providing for set amount of lease payments to be applied to purchase of property.

**Ledger:** in accounting, book of permanent records containing series of accounts to which debits and credits of transactions are posted from books of original entry.

**Legal and Sovereign Risk:** risk that government may intervene to affect bank’s system or any participant of such system detrimentally.

**Legal Composition:** identification and description of lawful ownership or title to business entity.

**Legal Description of Real Property:** exact description of a parcel of land as it appears on the public records.

**Legal Entity:** business organization that has capacity to make contract or agreement or assume obligation. Such organization may consist of individual proprietorship, partnership, corporation, or association.

**Legal Right:** natural right, right created by contract, and right created or recognized by law.

**Legal Tender:** any money that is recognized by law for payment of debt unless contract exists specifically calling for payment in another type of money.

**Legal Title:** document establishing right of ownership to property that is recognized and upheld by law.

**Lender:** one who extends funds to another with expectation of repayment with interest.

**Lender Liability:** the potential for a lender to be held liable for damages, if found to be responsible for management decisions that are detrimental to a clients business.

**Lender’s Loss Payable Endorsement:** form attached to property insurance policies to cover lender’s interest in what is insured; extends coverage to give lender protection beyond that in basic policy; language may be prescribed by banking industry, standard form prepared by insurance industry, or specified by lender. See also *Loss Payee Clause*.

**Lending Value:** is the value of an asset as determined by a lender to be the realistic value of an asset, and is often based on either book value or market value.

**Lessee:** one to whom lease is given and therefore has right to use property in exchange for rental payments.

**Lessor:** owner who grants lease for use of property in return for rent.
**Letter of Agreement:** letter stating terms of agreement between addressor and addressee, usually prepared for signature by addressee as indication of acceptance of those terms as legally binding.

**Letter of Attornment:** letter from the landlord to a tenant advising that the property has been sold and directing the tenant to remit lease payments to the new owner.

**Letter of Credit:** letter or document issued by bank on behalf of customer that is evidence of financial background of bank and ensures that payment will be made when proper documents confirm completion of related transaction. Such letters authorize drawing of sight or time drafts when certain terms and conditions are fulfilled. See also Banker’s Acceptance, Draft, Sight Draft, Standby Letter of Credit, and Time Draft.

**Letter of Intent:** letter signifying intention to enter into formal agreement and usually setting forth general terms of such agreement.

**Level-Payment Plan:** amortization plan that provides for equal monthly payments covering both principal and interest during the term of the mortgage. Part of each payment is applied to interest as earned, and the rest is credited to principal.

**Leverage:** the degree to which a business is utilizing borrowed money. Frequently calculated as a debt to worth ratio.

**Leveraged Financing or Levered Financing:** is providing more debt to a company than would be would be considered within normal guidelines for that company or industry. Because it riskier, it is often more costly. Leveraged Financing is generally provided for a temporary specific purpose with the source and time of payment clearly defined when the loan is made.

**Levy:** an exaction of payments or services by a public authority.

**Liable:** duty or obligation enforceable by law.

**Liabilities:** indebtedness of an individual or entity.

**Libel:** written or published false and malicious statements about another that tend to defame or harm other’s reputation.

**LIBOR:** see London Interbank Offered Rate.

**Lien:** legal right or encumbrance to secure payment performance on property pledged as collateral until debt, which it secures, is satisfied. Refer Charge.

**Lien Filing:** the recording of a legal claim against an asset, often in order to perfect collateral for a credit extension. Such a recording is usually made under the terms of the Personal Property Security Act.
Lien Waver: document signed by a contractor or subcontractor upon receipt of payment for an amount requested by a construction draw, acknowledging receipt of the funds, and legally waiving the right to lien the job.

LIFO: see Last-In First-Out.

LIFO Reserve: LIFO Reserve is an accounting of the difference of the value inventory at a point in time calculated on the LIFO rather than the FIFO basis.

Limited Liability Company: legal entity that offers shareholders the same limitations on personal liability that are available to corporate shareholders. The owners of a limited liability company (LLC) have limited liability. They are not liable for the debts, liabilities, acts, or omissions of the company. Only their investment is at risk.

Limited Liability: legal exemption corporate stockholders or limited liability companies have from full financial responsibilities for debts of company.

Limited Partnership: partnership of, one or more general partners who are personally, jointly, and separately responsible, and one or more special partners whose liabilities are limited to amount of investment.

Limited Personal Guarantee: an individual’s assurance to make good the debt of another individual business or entity, with a specific limit as to the amount of that undertaking.

Limited Reduction Plan: amortization plan that provides for only a limited amount of principal reduction prior to the expiration date of the loan.

Line of Credit: see Credit Line.

Liquid Assets: assets that can be readily converted into cash.

Liquidate: 1. to pay off or settle current obligation. 2. to sell off or convert assets into cash. 3. to dissolve business in order to raise cash for payment of debts.

Liquidated Collateral: assets pledged to secure a loan are referred to as Collateral; Liquidated collateral is that collateral that a lender has realized in order to repay a loan.

Liquidation: process of dissolving a business, settling accounts, and paying off any claims or obligations with distribution of remaining cash to the owners of a business.

Liquidation Value: cash that can be realized from sale of assets in dissolving business, as distinct from its value as ongoing entity.

Liquidity: quality that renders an asset convertible into cash on short notice by sale in the open market or by rediscount, usually at a minimum of loss.

Liquidity Ratio: company’s most liquid assets (generally cash and accounts receivable) divided by current liabilities. Also called Acid Test, Quick ratio or Quick Asset Ratio.
**List Price:** generally advertised or posted price. Sometimes subject to trade or cash discounts.

**Litigation:** lawsuit brought to court for purpose of enforcing a right.

**Living Trust:** a living trust is one created by and for an individual (“the Trustor”) while the trustor is still alive. It may be either revocable or irrevocable. A Living Trust eliminates probate thereby enabling assets to be distributed with less delay than with a will. It also provides confidentiality, as it is not subject to the public record requirements of probate proceedings.

**LLC:** see *Limited Liability Company*

**Loan:** money advanced to a borrower with agreement of repayment usually with interest within a specified period of time.

**Loan Agreement:** legal contract between a financial institution and a borrower that governs the terms and conditions for the life of a loan. Elements usually include description of loan, representations, and warranties reaffirming known facts about the borrower such as legal structure, affirmative and negative covenants, conditions that must be met before the loan is granted, delinquent payment penalties, and statement of remedies that the financial institution may take in event of default.

**Loan Closing:** see *Closing a Mortgage Loan*.

**Loan Covenants (Covenants):** clause(s) in a credit agreement that require one party to do (affirmative covenant), or refrain from doing (negative covenant), certain things. Sometimes referred to as restrictive covenants, they are negotiated and set at the time of the granting of the credit facility.

**Loan Participation:** sharing of loan(s) by a group of financial institutions that join together to make said loan(s), affording an opportunity to share the risk of a very large transaction. Arranged through correspondent banking networks in which smaller financial institutions buy a portion of an overall financing package. Participations are a convenient way for smaller financial institutions to book loans that would otherwise exceed their legal lending limits. Also called participation financing.

**Loan Policy:** principles that reflect financial institution’s credit culture, underwriting procedures, and overall approach to lending.

**Loans Past Due:** loans with interest or principal payments that are contractually past due a certain number of days.

**Loan-to-Cost:** ratio between the amount of a loan and the total cost to build or acquire the collateral.

**Loan Term:** period of time extending from the original date of the loan and the date of its stated maturity.
Loan-to-Value Ratio (LTV): relationship, expressed as percent, between principal amount of loan and appraised value of asset securing financing.

Loan Value: amount of money that can be borrowed against real or personal property.

Lockbox: regional financial institution depository used by corporations to obtain earlier receipt and collection of customer payments. Arrangement provides creditor with better control of accounts receivable and earlier availability of cash balances. Many large financial institutions offer lockbox processing as a cash management service to corporate customers. Lockboxes can be:

- retail, designed for remittance processing for consumer accounts.
- wholesale, in which payments from other entities are collected and submitted through depository transfer check or electronic debit into a concentration account for investment and disbursement as needed.

London Interbank Offered Rate (LIBOR): key rate index used in international lending. LIBOR is the rate at which major financial institutions in London are willing to lend U.S. dollars or Eurodollars to each other. This index is often used to determine interest rate charged to creditworthy borrowers.

Long-Term Assets: on a balance sheet, those assets (Property, equipment and other capital assets) that will not, in the normal course of business, be converted into cash in one year.

Long-Term Capital Gain (Loss): gain or loss realized from sale or exchange of capital asset held for longer than 12 months.

Long-Term Liabilities: all senior debt, including bonds, debentures, bank debt, mortgages, deferred portions of long term-debt, and capital lease obligations owed for longer than 12 months.

Loss: 1. circumstance in which expenses exceed revenues. 2. results if an asset is sold for less than its depreciated book value.

Loss Assets: assets considered uncollectible and of such little value that their continuance as realizable assets is not warranted.

Loss Leader: deliberate sale of product or service at or below cost in order to attract new customers.

Loss Payee Clause: provision in insurance policy or added by endorsement to cover lender/mortgagee’s interest in property loss settlement. Provision is not as broad as lender’s loss payable endorsement. Also called mortgagee clause and loss payable clause.

Lower of Cost or Market: 1. a method of valuing investments on a balance sheet at a value equal to the lower of cost or their current market value. 2. the inventory valuation method in which case the raw materials in inventory are valued at the lesser of the purchase price, or what the current purchase price is. Any write-down in the valuation of inventory is included as an expense under COGS.
**LTV:** see *Loan-to-Value Ratio.*

**Lump-Sum Settlement:** payment made in full with single, one-time payment.

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**M**

**Magnetic Ink Character Recognition (MICR):** description of numbers and symbols that are printed in magnetic ink on documents for automated processing. Fully inscribed MICR line of information may include item’s serial number, routing and transit number, check digit, account number, process control number, and amount.

**Mail Teller:** employee of a financial institution who receives mail deposits, checks them for accuracy, and returns stamped receipts for deposits to customers.

**Majority Stockholder:** person or entity that owns more than 50% of voting stock of a corporation, thereby having controlling interest.

**Maker:** one who signs or executes negotiable instrument.

**Malpractice:** professional misconduct with negligence.

**Management:** persons responsible for administrating and carrying out policy of business or other organization.

**Management Information System (MIS):** established flow of information developed to keep managers informed of what is happening within their organization and to do it within a time frame that permits effective reaction when required. Efficient MIS helps managers make better decisions.

**Management Report:** statement in unaudited financial statements that says that financials are representations of firm’s management.

**Manifest:** shipping document that lists freight’s origin, contents, value, destination, carrier, and other pertinent information for use at terminals or custom house.

**Manufacturers Representative (Agent):** independent, commissioned sales agent who represents several noncompeting manufacturers for sale of their products to related businesses within agreed, exclusive sales territory.

**Margin Stock:** stock purchased on margin, using money borrowed from a dealer/broker against existing stock held by the dealer/broker for account of the purchaser.

**Marginal Account:** borderline credit risk that does not have sufficient operating capital and from which payment may be delayed.

**Markdown:** price reduction of goods below normal selling price.
**Market:** 1. customer base for a company’s goods or services. 2. securities exchange and its associated institutions.

**Marketability:** ease and rapidity with which product, service, or other asset can be sold or converted to cash.

**Marketable Securities:** on a balance sheet, investments in securities that can be easily converted into cash. Such securities are usually listed on highly liquid markets enabling valuation daily and allowing sale to take place without delay.

**Marketing:** 1. activities necessary to facilitate the sale of goods or services through planned research, manufacturing, promotion, advertising, and distribution. 2. Business promotion devoted to getting the maximum amount of products or services purchased by consumers.

**Market Rent:** rental income a property would command in the open market based upon the highest and best use of the property.

**Market Risk.** risk that is common to an entire class of assets or liabilities.

**Market Value:** the most probable price a property should bring in a competitive and open market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently and knowledgeably and assuming the price is not affected by undue stimulus. Implicit is consummation of a sale as of a specified date and passing of title from seller to buyer under conditions whereby:

- Buyer and seller are typically motivated.
- Both parties are well informed or well advised and each acting in his or her own best interest;
- A reasonable time is allowed for exposure in the open market.
- Payment is made in terms of cash or in terms of financial arrangements comparable thereto.
- The price represents normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.²

**Marketable Title:** title to property that can be conveyed without inherent defects or clouds, which would impair its value to a new owner.

**Markup:** amount or percentage added to cost of goods to arrive at selling price.

**Master Lease:** lease governing subsequent leases, or the lease of an entire property with a view toward subletting.

**Materialmen:** suppliers of material needed in construction.

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² Ibid.
**Matrimonial Property**: property shared by husband and wife. Matrimonial property is regulated by the Jurisdiction in which it is located. For example, the Dower Act in Alberta.

**Maturity Date**: date when financial obligation, note, draft, bond, or instrument becomes due for payment.

**Mechanics Lien**: enforceable claim, permitted by law in most Jurisdictions, securing payment to contractors, subcontractors, and suppliers of materials for work performed in constructing or repairing buildings. Lien attaches to real property, plus buildings and improvements situated on land, and remains in effect until workers have been paid in full or, in event of liquidation, gives contractor priority of lien ahead of other creditors.

**Median**: the middle term in a series when all the items are arranged in the order of magnitude.

**Medium of Exchange**: money or commodity accepted in payment or settlement of debt.

**Memorandum (Consignment) Sale**: sale of goods for which seller is not paid until retailer has sold merchandise. Seller retains title to such goods until retailer has sold merchandise and payment is made to retailer.

**Mercantile Agency**: organization that compiles credit and financial information and supplies subscribers or members with reports on applicants for credit; can also perform other functions such as collection of accounts or statistical trade information compiling.

**Merchandise Shortage**: goods purchased but not included in shipment.

**Merchandising**: process of distributing a product or a service by systematic and carefully planned promotion and directed sales effort.

**Merchantable Title**: that condition of title acceptable in the market.

**Merger**: combining of two or more businesses to form single organization.

**Mezzanine Financing**: 1. in corporate finance, leveraged buyout or restructuring financed through subordinated debt, such as preferred stock or convertible debentures. Transaction is financed by expanding equity, as opposed to debt. 2. second- or third-level financing of companies financed by venture capital. Senior to venture capital but junior to financial institution financing, it adds creditworthiness to firm. It generally is used as intermediate stage financing, preceding company’s initial public offering, and is considered less risky than start-up financing.

**MICR**: see *Magnetic Ink Character Recognition*.

**Middle-of-Month (M.O.M.) Billing Term**: billing system in which all shipments are charged on one invoice issued twice a month. For first half of month, credit period runs to the twenty-fifth, and for the second half, to the tenth of the following month.

**MIS**: see *Management Information System*. 

65
Modified Accrual Accounting: basis of accounting in which expenditures are recognized when liability is incurred. Revenues are recognized when measurable and available. Exception is in debt service funds in which expenditures are recorded only when due.

M.O.M.: see Middle-of-Month Billing Term.

Money Judgment: court decision that adjudges payment of money rather than requiring act to be performed or property transferred.

Moratorium: 1. temporary extension or delay of normal period for payment of account. 2. Formal postponement during which debtor is permitted to delay payment of obligations.

Mortgage: instrument of conveyance (generally real estate) from a borrower, called the mortgagor, to the lender, called the mortgagee. It is only a “conditional conveyance” in that the property remains with the use and occupancy of the mortgagor as long as the mortgagor lives up to the mortgage conditions. The major conditions are the continual payment of interest and principal reduction as set forth in the document. When the money is loaned by the mortgagee to the mortgagor, the mortgage is signed by the borrower, or mortgagor, and given to the mortgagee, who has the right to foreclose, or exercise a right to take over the property, in case the mortgagor fails to meet his or her obligation under the terms of the mortgage. It should always be filed in the records of the county seat where the real estate property is located.

Mortgage Bond: see Bond.

Mortgage Department: department in banks, building and loan, savings and loan associations, and trust companies where mortgage counselors, mortgage loan officers, and mortgage-recording personnel handle all phases of mortgage work for mortgagors. It may also act as escrow agents for mortgagors, in that it collects in the monthly payment from the mortgagor a portion of the real estate taxes, assessments on real estate, and hazard insurance. These are held in escrow funds until payable and are then disbursed for the benefit of the mortgagor, and also the mortgagee, to prevent the development of liens against the property. In some states, mortgage departments administer escrow funds in connection with the closing mortgages, whereas in other states mortgage loan closings are required to be handled by attorneys-at-law.

Mortgage Lender: lender who specializes in mortgage financing; an operator of a mortgage financing company. Mortgage financing companies are mortgagees themselves, as well as mortgage agents for other large mortgagees. Serving as mortgage agents, these mortgage lenders collect payments, maintain complete mortgage records, and make remittances to the mortgagees for a set fee or service charge. They also disburse funds for taxes, insurance, etc., as escrow agents.

Mortgage Loan: loan made by a lender, called the mortgagee, to a borrower, called the mortgagor, for the financing of a parcel of real estate. The loan is evidenced by a mortgage. The mortgage sets forth the conditions of the loan, the manner of repayment or liquidation of the loan, and reserves the right of foreclosure or repossession to the mortgagee. In case the mortgagor defaults in the payment of interest and principal, or if he or she permits a lien to be placed against the real estate mortgaged due to failure to pay the taxes and assessments levied
against the property, the right of foreclosure can be exercised. **Mortgage Insurance Premium:**
premium or fee paid for a contract of insurance against loss arising from a mortgage transaction.

**Mortgage Note:** see *Note*.

**Mortgage Portfolio:** aggregate of mortgage loans or obligations held by a bank as assets.

**Mortgage Risk:** hazard of loss of principal or of anticipated interest inherent in an advance of funds on the security of a mortgage.

**Mortgagee:** lender who arranges mortgage financing, collects loan payments, and takes security interest in property financed.

**Mortgagee Clause:** provision in property policy, or added by endorsement, that extends protection, in limited manner, to mortgagee; not as broad as lender’s loss payable endorsement.

**Mortgagee Waiver:** relinquishment of a right(s) contained in a mortgage by a mortgagee.

**Mortgage Verification:** request made by mortgagee to applicant’s financial institution for information on applicant’s accounts, as part of mortgagee’s credit approval process.

**Mortgagor:** borrower in a mortgage contract who mortgages property in exchange for a loan.

**Multinational Corporation:** corporation whose operations are conducted on international basis.

**Multiple-Signature Credit Approval:** describes credit approval process in which credit is approved by two or more persons acting together.

**N**

**NACM:** see *National Association of Credit Management*.

**Negative Cash After Operations:** calculated in a “Direct Cash Flow Statement” it is an indication that a concern was unable to finance its operations from internal sources.

**Negative Pledge:** a negative covenant which restricts the pledging of security for other debt, which can either be limited to a threshold level or prohibited. In some cases, if existing facilities are unsecured, the negative pledge may provide for provision of security to the existing lender on a pari passu basis if the borrower provides security to any other lender.

**Negligence:** failure to use reasonable care that a prudent person ordinarily would in like circumstances.

**Negotiable:** anything capable of being transferred by endorsement or delivery.

**Negotiable Instrument:** any written evidence of indebtedness, transferable by endorsement and delivery or by delivery only, that contains unconditional promise to pay specified sum on demand or at some fixed date.
**Negotiate**: to discuss, bargain, or work out plan of settlement, terms, or compromise in business transaction.

**Neighborhood**: 1. district or area of limited but frequently indefinable extent characterized by similarity or uniformity of customs, traditions, structures, inhabitants, or other attributes that create a sense of community of interest. 2. immediate environment of a property.

**Net**: amount left after necessary deductions have been made from gross amount.

**Net Assets**: sum of individual’s or entity’s total assets less total liabilities.

**Net Cash After Operations**: calculated in a “Direct Cash Flow Statement” it is the sum of cash available to the concern from operations to meet financing costs, term debt payments and any investments in fixed assets.

**Net Cash Flow After Operations (NCAO)**: as in Net Cash After Operations.

**Net Cash from Operations**: calculated in a “Direct Cash Flow Statement” it is the sum of cash available to the concern from operations to meet financing costs, term debt payments and any investments in fixed assets.

**Net Cash Income**: calculated in a “Direct Cash Flow Statement” it is that amount of cash generated by a concern after all cash operating income and expenses, including miscellaneous items, taxes and financing costs have been taken into account.

**Net Earnings**: total sales, less total operating, administrative, and overhead expenses, but before other expenses and income such as interest and dividends.

**Net Fixed Assets Turnover**: Net Sales divided by Net Fixed Assets. This is a measure of the financial efficiency with which a concern uses its Plant and Equipment

**Net Income**: amount of income remaining after deducting all expenses from total revenues.

**Net Lease**: agreement in which tenant assumes payment of other property expenses, such as taxes, maintenance, and insurance, in addition to rental payments.

**Net Margin**: Net Profit divided by net revenues, often expressed as a percentage. This number is an indication of how effective a company is in cost control. Also called Net Profit Margin.

**Net Operating Income (NOI)**: income generated by an income-producing property after payment of all property-related expenses, but before debt service. Costs do not include depreciation, capital expenditures, or expenses not related to real estate.

**Net Operating Profit**: Gross profit minus operating expenses.

**Net Price**: actual price paid after all discounts, allowances, and other authorized deductions have been taken.
**Net Profit:** income earned by business over specific period of time. Profit from transaction or sale, after deducting all costs, expenses, and miscellaneous reserves and adjustments from gross receipts.

**Net Rentable Area:** Space occupied by a tenant plus additional space for a proportionate of common areas.

**Net Sales:** total sales less returns, allowances, and discounts.

**Net Working Capital:** current assets less current liabilities; used as measure of a company’s liquidity and indicates its ability to finance current operations.

**Net Worth:** total assets less total liabilities, reflects owners’ net interest in company.

**Net Yield:** return obtained from an investment after deduction of costs and losses involved in procuring and managing the investment. See also *Gross Yield*.

**No Account:** notation on rejected check when check writer does not have account at the financial institution on which check is drawn.

**No Asset Case:** insolvent or bankrupt estate with no assets available for payment of creditors’ claims.

**No Funds or Insufficient Funds (NSF):** notation on rejected cheque when cheque writer has account but not funds to cover check.

**Nominal Balance:** RMA general figure range description of account balance of less than $100.

**Nominal Owner:** person whose name appears on title to asset, but who has no interest in it.

**Non-accrual:** loan on which a financial institution does not accrue interest, also known as a non performing loan.

**Non-borrowing Account:** banking relationship in which no extension of credit is involved.

**Non-financial Information:** facts used to evaluate a customer’s creditworthiness that focuses on background and history rather than financial measures.

**Non-Institutional Quality Property:** financed property that does not meet the investment criteria of institutional investors. The cash equity is the actual dollars the borrower has invested, or at risk, in the property; the borrower’s tangible “stake” in the deal. Market equity, in loose terms, is the amount by which the current property value exceeds the amount the owner paid for that property, or the owner’s cost basis in the property.

**Non-Operating Cash Flow:** Calculated in a “Direct Cash Flow Statement” it is that amount of cash generated by a concern from areas other than operations. This amount is included in the miscellaneous Income/Expense section of the statement.
Non-payment: failure or neglect to pay or discharge debt in accordance with terms of agreement.

Non-performing Assets: total of earning assets listed as nonaccrual.

Non-performing Loans: amount of loans not meeting original terms of agreement, including renegotiated, restructured, and nonaccrual loans. Loans included in this total vary according to bank policy and regulation.

Non-profit Corporation: organization specifically classified by the CRA as generally tax exempt whose primary purpose for existence is to provide services of charitable, fraternal, religious, social, or civic nature.

Non-recourse: inability of holder in due course to demand payment from endorser of debt instrument if party(ies) primarily liable fail to make payment.

Non-Sufficient Funds (NSF): term used when collected demand deposit balances are less than the amount of the cheque being presented for payment and cheque is returned to payee’s financial institution. See also Overdraft.

North American Industrial Classification System (NAICS): the Standard Industrial Classification (SIC) code is being replaced by the NAICS code. NAICS classifies establishments by their primary type of activity within a six-digit code. NAICS provides structural enhancements over SIC and identifies over 350 new industries. See also SIC and Standard Industrial Classification.

Notary Public: public officer authorized to administer oaths, attest and certify certain types of documents, and to take acknowledgements of conveyances.

Note: unconditional written promise by borrower to pay certain amount of money to lender on demand or at specified or determinable date. This instrument should meet all requirements of laws pertaining to negotiable instruments.

Notes Payable: liabilities represented by promissory notes, excluding trade debts, that are payable in future.

Notes Receivable: assets represented by promissory notes, excluding amounts due from customers for credit sales, to be collected in future.

Notice to Reader or Compiled Statements: financial statements prepared by an outside third party (does not have to be an Accountant) based strictly upon the representations of the producing individual or business entity. The reader has no assurance that the statements have been prepared in accordance to GAAP. Caution must be exercised in using such statements for the purpose of financial analysis as the quality of such statements relate more directly to the integrity and skills of the producing company or individual and not the third party that produced the statements.
Novation: substitution of old contract for new one between same or different parties; substitution of new debtor or creditor for previous one, by mutual agreement.

NSF: see Non-Sufficient Funds.

Objective Value: price that an economic good can command in terms of other goods in the market.

Obligation: 1. law or duty binding parties to agreement. 2. written promise to pay money or to do a specific thing.

Obligee: person or entity to which payment is due.

Obligor: person or entity required by contract to perform specific act.

Obsolescence: decline in perceived value of asset, frequently because of technological innovations, changes in an industry’s processes, or changes required by law. In appraisal terms it includes functional, economic, locational, environmental, or physical obsolescence of a real property.

Occupancy: percentage of space in a rental property occupied by tenants. There are two variations: 1) physical occupancy meaning actual percentage occupied, and 2) economic occupancy being the percentage of actual NOI received relative to maximum potential NOI.

Offer: proposal to make contract, usually presented by one party to another for acceptance.

Offering Basis: customer’s loan requests considered individually on merits of each proposal.

Office of the Superintendent of Financial Institutions (OSFI): was established in 1987 by an Act of Parliament – Office of the Superintendent of Financial Institutions Act. It has the responsibility to regulate all financial institutions in Canada and includes all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and pension plans.

Offset: amount allowed to be netted against another.

Off-sites: construction and development of the necessary access to and from the property, connection to utilities, and any additional infrastructure work typically required by the permitting authorities and not located on the property being financed.

On Account: generally describes partial payment made toward settlement of unpaid balance.

On-Account Payment: partial payment not intended as payment in full.

On Demand: debt instrument that is due and payable on presentation.
On-sites: construction and development necessary to prepare the site for the construction of the premises, including such things as clearing, grading, retaining walls, and retention ponds, drainage, extension of utility connections from the site perimeter to the building “pad,” and landscaping.

Open (Book) Account: credit extended without a formal written contract and represented on books and records of the seller as an unsecured account receivable for which payment is expected within a specified period after purchase.

Open-End Credit: consumer line of credit that may be added to, up to preset credit limit, or paid down at any time. Customer has option of paying off outstanding balance, without penalty, or making several installment payments. Contrasts with Closed-End Credit. Also called revolving credit or charge account credit.

Open-End Mortgage: a mortgage given to secure both an original loan and loan advances to be made at a future date.

Open Mortgage: a past-due mortgage held by the mortgagee without requiring refinancing or the execution of an extension agreement.

Open Terms: selling on credit terms as opposed to having customer pay cash.

Operating Asset Efficiency: an assessment of the financial effectiveness in which operating assets have been managed by the management of a concern.

Operating Cash Flow (OCF): calculated in a “Direct Cash Flow Statement” it is that amount of cash generated by a concern from its usual operations. Also referred to as “Cash After Operations”.

Operating Cash Flow and Margins: calculated in a “Direct Cash Flow Statement” it is that amount of cash generated by a concern from its usual operations. The Margin is that amount divided by total cash revenues/sales. This margin measures the extent to which cash operating expenses use up revenue.

Operating Cycle: the average time between acquiring inventory and receiving cash proceeds of sale.

Operating Efficiencies: a measure of the efficiency of the management of a concern by dividing total revenues by operating expenses. Typically, the higher the ratio the more efficient the management.

Operating Leases: a lease in which the lessee acquires the right to use property or equipment for only a portion of its useful life without the transfer of ownership or title. Operating leases are off-balance sheet but should be included in Notes to Financial Statements.

Operating Leverage: fixed operating costs divided by total (fixed plus variable) operating costs.

Operating Margin: operating income divided by revenues, expressed as a percentage.
**Operating Performance Ratios**: financial measures designed to assist in evaluation of management performance.

**Operating Section of the Direct Cash Flow Statement**: that portion of the Direct Cash Flow Statement covering Sales/Revenues, Production Costs, Operating Expenses, Miscellaneous Items and Taxes.

**Operating Statement**: report of an individual’s or entity’s income and expenses for specified period of time. See also *Income Statement*.

**Operative Builder**: builder who constructs houses for sale rather than for owners on contracts.

**Operational Risk**: risk concerning computer network failure due to system overload or other disruptions; also includes potential losses from fraud, malicious damage to data, and error.

**Option Exercise**: the action of converting stock options into actual stock.

**Oral Contract**: agreement that may or may not be written in whole or in part or signed but is legally enforceable.

**Order**: informal bill of exchange or letter or request identifying person to be paid.

**Order for Relief**: order issued by bankruptcy court judge upon filing of petition by debtor or filing of petition by creditors.

**Order to Order**: agreement for payment to be made for prior shipment before next delivery will be made.

**Orderly Liquidation Value**: an estimate of the value of assets of a concern based on their sale over a period of time sufficient to find a willing buyer at a reasonable price. The opposite to a forced sale value which is based on a speedy liquidation at whatever price is available.

**OREO**: see *Other Real Estate Owned*.

**Origination Fee**: a fee charged by a bank to a borrower to cover costs associated with the initiation of a loan.

**OSFI**: Office of the Superintendent of Financial Institutions.

**Other Real Estate Owned**: 1. real property usually taken as collateral and subsequently acquired through foreclosure, or by obtaining a deed in lieu of foreclosure, in satisfaction of the debts previously contracted. 2. Real property formerly used as banking premises. Often referred to as Real Estate Other than Bank Premises.

**Outlet Store**: retail operation where manufacturers’ production overruns, discontinued merchandise, or irregular goods are sold at discount.

**Out-of-Court Settlement**: 1. settlement made by distressed debtor through direct negotiations with creditors or through creditors’ committee; acceptance of such settlement is not obligatory to
non-consenting creditors. 2. agreement reached between opposing parties to settle pending lawsuit before matter has been decided by court.

**Out-of-Pocket Expense:** 1. business expenses for which individual pays. 2. Costs associated with negotiating, documenting, securing and collection of a loan that are incurred by the financial institution but for the account of the borrower.

**Out-of-Trust:** event occurring in floor plan financing where a borrower sells inventory securing the financial institution’s loan and fails to promptly remit the proceeds to the financial institution in accordance with the loan agreement. Also referred to as Sold Out of Trust (SOT).

**Outstanding:** 1. amount of credit facility that is being used versus total amount made available. 2. unpaid or uncollected account.

**Overadvance:** when the amount outstanding on a formula driven line of credit exceeds the amount calculated as available under the formula, the amount over the formula is considered to be an overadvance.

**Overall Rate:** capitalization rate including cash on cash return, capital appreciation, and return of principal on mortgage financing.

**Owned Real Estate:** a term that applies to all real estate directly owned by a bank, usually not including real estate taken to satisfy a debt. Real Estate Owned

**Overdraft:** negative account balance created when demand deposit balances are less than amount of the check being presented for payment. See also [Non-Sufficient Funds](#).

**Overdue:** debt obligation on which payments are past due.

**Overhead:** selling and administrative business costs as contrasted with costs of goods sold.

**Oversold:** condition in which manufacturer or wholesaler finds itself after taking more orders than it can deliver within agreed period of time.

**Owed:** debt that is due and payable.

**Own:** to have legal title to property.

**Owner:** person or entity that owns or has title to property.

**Owner Equity Measures:** basic lending principles require the borrower to maintain a “stake” in the deal. That “stake” is typically measured in terms of the owner’s dollar exposure in the transaction; their equity position. In real estate lending there are two types of equity to consider: cash equity and market equity. The cash equity is the actual dollars the borrower has invested, or at risk, in the property; the borrower’s tangible “stake” in the deal. Market equity, in loose terms, is the amount by which the current property value exceeds the amount the owner paid for that property, or the owner’s cost basis in the property. Underwriting guidelines address both types of equity via the following measures: [Cash Equity](#), [Loan-to-Cost](#), and [Loan-to-Value](#).
**Owner’s Equity:** mathematical difference between total assets and total liabilities that represents shareholders’ equity or an individual’s net worth.

**Ownership:** exclusive rights that one has to property, to exclusion of all others; having complete title to property.

**Owner’s Risk:** term used in transportation contracts to exempt carrier from responsibility for loss or damage to goods.

**Packing List:** detailed listing of information on contents of shipment enclosed for inspection with package.

**Pad:** An improved site available for construction.

**Paid Direct:** payment made by debtor directly to original creditor instead of to collection agency or attorney handling account for collection.

**Paper Profit:** unrealized income or gain on asset.

**Paralegal:** trained aide to attorney who handles various legal tasks.

**Parent Company:** an entity that holds controlling majority interest in subsidiaries.

**Pari Passu:** “Of equal step”[Latin] Often seen in term sheets in reference to the ranking of equity investments or creditors that have the same rights and privileges.

**Parking Ratio:** ratio of parking spaces to the square footage of the site or property. Zoning regulations typically require a minimum parking ratio.

**Partial Payment:** payment not in full for amount owed.

**Participation:** purchase or sale of a loan or credit facility among two or more financial institutions in which the acquiring institution(s) has no formal or direct role in establishing the terms and conditions binding the borrower. Participants do not participate in the document negotiation between the originating financial institution and the borrower.

**Participation Certificate:** instrument that evidences a proportionate interest in a security or group of securities held by a trustee for the benefit of a group of investors.

**Partner Draws:** Amounts withdrawn from a Partner’s capital account, included in the partnership financial statements, tax returns or shown on Form T5013.

**Partnership:** business arrangement in which two or more persons agree to engage, upon terms of mutual participation, in profits and losses.
Partition Suit: court action to separate common interests in real estate and to assign full ownership of a designated portion of the property to each of the parties previously holding an interest in common.

Party: person concerned or taking part in a transaction or proceeding.

Pass-Through: lease provision where expenses are passed directly through to a tenant rather than being paid by a landlord and passed through to a tenant.

Past Due: payment or account that remains outstanding and unpaid after its agreed upon payment or maturity date.

Pay: to satisfy, or make partial payments on, a debt obligation.

Payable: obligation that is due now or in future.

Payable Days: the average number of days that an account payable is outstanding. Calculated by dividing one day's sales into the balance of the accounts payable account.

Payables: liabilities owed to trade creditors for purchase of supplies. Also called accounts payable.

Payee: person or entity named on a negotiable instrument as the one to whom the obligation is due.

Payer: party responsible for making payment as shown on check, note, or other type of negotiable instrument; also called maker or writer.

Payment: discharge, in whole or in part, of a debt or performance of agreement.

Payment for Honor: payment of past due obligation by someone else to save credit or reputation of person responsible for payment.

Payoff: receipt of payment in full on an obligation.

Penalty: 1. legal fine, forfeiture, or payment imposed for defaulting or violating terms of contract. 2. interest charge imposed for late payments permissible by law and imposed with customer’s prior agreement or knowledge of seller’s terms of sale.

Percentage Lease: lease of real property in which rental payments are based on percentage of retailer’s sales.

Percentage of Completion: method of accounting commonly used by contractors and developers, in which costs are related to percentage of job completion.

Perfection: with respect to security interests in personal property under the PPSA, the action required to give the secured party rights in the collateral as against third parties with competing claims. In general, a security interest is not perfected until a security agreement has been signed.
and a properly executed financing statement has been recorded or the secured party is in the possession of the collateral, whichever applies as to that specific collateral type.

**Performance:** fulfillment of promise or agreement according to terms of contract or obligation.

**Performance Bond:** bond supplied by one party to another protecting that party against loss in the event of improper performance or completion of the terms of an existing contract.

**Perjury:** willfully and knowingly giving false testimony under oath.

**Permanent Lenders:** providers of long-term, fully amortizing property refinancing, which include insurance companies, pension funds, and institutional investors.

**Permanent Loan:** long-term mortgage or deed of trust—fully amortizing.

**Perpetual Inventory Accounting System:** an inventory system that continually provides an actual value by updating daily by taking into account sales and receipts of materials, etc.

**Person:** individual (natural person) or incorporated enterprise (artificial person) having certain legal rights and responsibilities.

**Personal Check:** check drawn by individual on his or her own bank account.

**Personal Property:** movable or chattel property of any kind. Any property that is not real property

**Personal Property Security Acts:** are Jurisdictional Acts covering the rules and regulations with respect to taking security on personal property. All Jurisdictions in Canada, with the exception of Quebec have Personal Property legislation. While Quebec legislation is under the Civil Code, the intent of the laws is similar, but the terminology is significantly different. The Acts in each Jurisdiction is similar to the others, but not necessarily identical. It is important to understand the differences in both the Jurisdiction where the debtor is located and any other Jurisdiction where registration is required to perfect a security interest.

**Personality:** legal term for personal property or possessions that are not real estate.

**Personally Liable:** individual’s responsibility for payment of obligation, generally used to refer to owner or guarantor responsibility.

**Petition:** written application, made in contradiction to motion. Also used in some Jurisdictions in place of complaint.

**Petition in Bankruptcy:** document filed in court to declare bankruptcy. Petition can be either voluntary, filed by debtor, or involuntary (filed by creditors depending on bankruptcy chapter rules).

**Petty Cash:** cash on hand or in designated bank account that is available for small, miscellaneous purchases.
**Physical Inventory:** inventory verification obtained by visual observation of items and itemization of quantities of goods on hand.

**Piercing the Corporate Veil:** legal action taken by creditor, when fraud or unjust enrichment may be involved, to hold principals of corporation (or other entities) liable for debts of corporation.

**PIK (Payment in Kind):** Typically used in reference to a payment-in-kind bond which provides the issuer the option of making interest payments in the form of additional bond debt rather than a payment of cash.

**Plaintiff:** person or entity that initiates legal action against another.

**Plan of Arrangement:** refer Arrangement.

**Plat:** map or plan of an identified area of land.

**Pledge:** promise of personal property as security for performance of act, payment of debt, or satisfaction of obligation.

**Points:** 1. percentage fee charged to get mortgage loan. 2. in shares of stock, one point equals $1.00.

**Policy:** 1. written statement by management that explains an organization’s philosophy and approach to doing business. 2. written contract of insurance between insured and the insurance company.

**Possession:** right to exclusive occupancy and use of real property.

**Postdated Check:** check written for payment, effective at future date.

**Postponement of Claim:** separate agreement by which a party (or parties) other than debtor who has funds invested in the company, commits not to withdraw money owed by the company.

**Power of Attorney:** written document, usually witnessed or acknowledged before a notary public or a lawyer, authorizing a named person to perform certain acts for the signer. It is usually void on the death of the signer.

**Power of Sale:** A power granted to sell a property under certain specific circumstances. Generally used in relation to a will, trust or mortgage.

**PPSA:** Personal Property Security Act

**PPSA Filing:** under the terms of the Personal Property Security Act a lien must be recorded at the appropriate recording office in order to perfect that lien against other liens. The priority of a lien under the PPSA is established by the time and date of filing rather than the date the document was executed. Refer to Dimension 6 for further particulars with respect to PPSA.
Preference: 1. right of a creditor to be paid before other creditors by virtue of having lien or collateral. 2. improperly paying or securing of one or more creditors, in whole or part, by an insolvent debtor to the exclusion of other creditors.

Preference Period: in bankruptcy, the 90-day period immediately preceding debtor entering into bankruptcy for third parties or the one year period for related parties. If a creditor files new or additional liens against a debtor during this time, such claims may be disallowed by bankruptcy court.

Preferred Creditor: creditor whose account takes legal preference for payment over claims of others.

Preferred Shares: capital stock that provides a specific dividend that is paid before any dividends are paid on common stock, and which takes precedence over common stock in the event of liquidation. In general there are four types of preferred shares; cumulative, non-cumulative, participating and convertible. Preferred shares are also known as preferred stock.

Prepaid Expenses: payment for goods or services not yet received.

Prepayment: payment of loan or debt before it actually becomes due.

Prepayment Penalty: special charge, provided for in a mortgage contract, that may be collected from the mortgagor if he or she repays all or a part of the loan in advance of the due date.

Prepayment Provision: privilege given the mortgagor, by a provision in the mortgage instruments, to pay all or any portion of the outstanding balance of the obligation prior to its due date without penalty.

Presale or Prelease Requirement: percentage of properties for sale or lease that must be under contract to qualify the project for financing.

Present Value: lump-sum amount that represents the current value of the right to collect future payments.

Price: amount, in the current medium of exchange, asked or received in exchange for an economic good.

Primary Reserves: assets of a bank, consisting of cash and balances on deposit with other banks that are immediately available for the payment of liabilities.

Prime Contractor: contractor who enters into contract with the owner of the project for completion of all or a portion of the project and takes full responsibility for its completion. See also General Contractor.

Prime Rate: an index or base rate published or publicly announced by a financial institution from time to time as the rate it is generally willing to give its most creditworthy customers.
**Principal:** 1. sum of money stated in a contract, an account, or a financial instrument as distinguished from the sum actually to be paid; in other words, the amount of a loan or debt exclusive of interest. 2. person who is primarily liable on an obligation. 3. person who appoints another person to act for him as agent.

**Priority:** legal preferences secured creditors have over general creditors in bankruptcy.

**Priority Lien:** lien recorded before other secured claims and payable ahead of other liens if liquidation of pledged collateral occurs. First mortgage has priority over second and third mortgages, known as junior liens. Secured creditor holding perfected security interest has priority over liens filed afterward.

**Private Enterprise:** business established to take economic risks for purpose of making profit.

**Privilege:** right that nature of debt gives to one debt holder over others.

**Proceeds:** actual amount of money given to or received from creditor after any deductions are made.

**Producers’ Goods:** See *Capital Goods*.

**Profit:** 1. amount of net income made by an entity in course of doing business. 2. increase in value of an asset over its depreciated book value at the time of sale.

**Profit and Loss Statement (P & L):** financial report of individual’s or entity’s revenue and expenses for given period of time. See also *Income Statement* and *Operating Statement*.

**Pro Forma:** a projected future balance sheet.

**Pro-Forma Balance Sheet:** a projected future balance sheet, compiled based on information available at the time of completion.

**Progress Billings:** invoices submitted for payment during the course of completion of a project, in accordance with a prior agreement. e.g. Invoices submitted as stages of construction are completed- foundations, walls, electrical, etc.

**Progress Payments:** partial payments made on a long-term contract as it progresses. Required when a manufacturer or contractor cannot afford, or does not wish, to finance a project.

**Project Finance:** is the provision of financing, generally for long-term infrastructure or industrial projects which is “non-recourse” or “limited recourse” to the sponsors of the project. In a non-recourse structure, the lender is relying strictly on cash flow generated from the project to repay the debt, and in limited recourse the lender has some specified but limited ability to request payment from the sponsors.

**Projection:** borrower’s estimate of future performance over designated time period.
**Promissory Note**: written promise to make unconditional payment of specified amount on designated date, signed by maker.

**Proof of Claim**: creditor’s formal document filed with court against estate of debtor if creditor is owed funds.

**Proof of Loss**: sworn statement filed by insured when making claim.

**Property**: something of value that is legally owned and in which person has exclusive and unrestricted right or interest.

**Property Insurance**: coverage that applies to loss caused by physical damage to property (buildings, contents, earnings, etc.) owned by insured.

**Proposal**: oral or written offer that, if accepted, constitutes a contract.

**Proprietorship**: single and exclusive ownership of a business by one person.

**Pro Rata**: share calculated in proportion to total amount.

**Pro Rata Distribution**: payment proportionate to uniform percentage of obligations to all creditors.

**Prospective Value Estimate**: forecast of the most probable value expected to occur at a specified future date. It is most frequently used in connection with real estate projects that are proposed, under construction, under conversion to a new use, or that have otherwise not achieved sellout or a stabilized level of long-term occupancy at the time the appraisal report is written. It is always based on the expectations and perceptions of market participants together with identifiable and documentable trends, as well as data known or knowable at the time the forecast is made. Therefore, it is not a prediction.

**Protest**: formal, written, notarized notice stating credit instrument has not been honored and that makers or endorsers will be held responsible for payment.

**Provincial**: referring to one of the ten Canadian provinces – British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, Nova Scotia, New Brunswick, Prince Edward Island or Newfoundland and Labrador.

**Proxy**: written statement or power of attorney, authorizing an individual to act or speak for another.

**Public Credit**: debt incurred by government, federal, provincial/territorial and local, for use in meeting the needs of its citizens.

**Purchase Money Security Interest**: under the PPSA, a priority claim against an asset established as the financier of the asset makes payment for the asset direct to the vendor or the seller’s rights to goods and products until the buyer makes payment. Under the PPSA, seller’s rights can take priority over lender’s general security rights if both claim interest in same
inventory. Lender may receive such priority if funds were provided to purchase asset, provided liens are filed within 15 days of borrowers taking possession of collateral and noticing requirements have been met. Lender may receive priority if funds were provided to purchase inventory only if the liens are filed prior to delivery of inventory. Refer to Dimension 6 for further discussion.

**Purchase Money Mortgage:** mortgage given by buyer to seller in lieu of cash, as partial payment on property.

**Purchasing Power:** value of money and its ability to buy goods and services in a given period.

**Q**

**QPP** – Quebec Pension Plan

**Qualified Acceptance:** agreement to terms of contract only if certain conditions are met. This constitutes counteroffer and rejection of original offer.

**Qualified Endorsement:** transfer of debt instrument to endorsee without recourse or liability to endorser.

**Qualified Financial Statement:** audit report issued by an independent Accountant that indicates restrictions on scope of audit performed, uncertainties, or disagreements with management.

**Qualified Prospect:** potential customer whose background and credit have been checked and approved.

**Quantity Discount:** price reduction extended to purchaser of large volume of goods.

**Quick Assets:** those current assets that can be readily converted into cash (generally, accounts receivable).

**Quick Ratio/Quick Assets Ratio:** cash and cash equivalents plus trade receivables divided by total current liabilities, used as measure of liquidity. Also referred to as Acid Test.

**Quid Pro Quo:** 1. giving of one valuable thing for another. 2. mutual consideration between parties to contract.

**Quitclaim:** to release or relinquish claim or title.

**Quitclaim Deed:** document by which the legal right, title, interest, or claim that one has in a specific property or to an estate is forever relinquished to another, but that usually contains no warranty or covenant of title (against the claims that others might have in the property).
Rack Jobber: wholesale distributor who sells housewares and other convenience type merchandise through retail stores and assumes responsibility for stocking and maintaining store’s inventory.

Rate of Exchange: amount of one country’s currency that can be bought with another country’s currency at a particular point in time.

Rate of Interest: cost of borrowing money, usually expressed as annual percentage charge.

Rating: 1. assessment of borrower’s financial strength and creditworthiness. 2. symbol used to denote borrower’s creditworthiness.

Ratios: mathematical relationship between two or more things, used as indication of company’s financial strength relative to other companies of comparable size or in same industry.

Real Estate Appraisal: an independent evaluation of the value of a specific piece of real estate based on the market, replacement costs and comparative sales. Usually expressed as the fair market value, that being what a knowledgeable buyer would pay a willing seller.

Real Estate Other than Bank Premises: 1. real property usually taken as collateral and subsequently acquired through foreclosure, or by obtaining a deed in lieu of foreclosure, in satisfaction of the debts previously contracted. 2. Real property formerly used as banking premises. Often referred to as Other Real Estate Owned.

Real Estate Owned: a term that applies to all real estate directly owned by a bank, usually not including real estate taken to satisfy a debt.

Real-Estate-Related Financial Transaction: any transaction involving:

- The sale, lease, purchase, investment in, or exchange of real property, including interests in property, or the financing thereof; or
- The refinancing of real property or interests in real property; or
- The use of real property or interests in property as security for a loan or investment, including mortgage-backed securities. 3

Real Property: land, buildings, and other improvements to property that may legally be classified as real in contrast to personal.

Realization Value: is the value that an asset could be sold for reasonably quickly. Generally used in the context of the realizable value of security if it needs to be liquidated to repay loans.

Reasonable Exposure Time: the amount of time the property has been assumed to be exposed on the open market prior to the effective date of the appraisal.

3 Ibid.
**Recapitalization:** change in a company’s capital structure such as an exchange of stock for bonds or debt. Often undertaken with the aim of making a company’s capital structure more stable or boost the price of the company’s stock. Sometimes used to deter a hostile takeover and often used as part of the reorganization of a bankrupt company.

**Receivables:** money due or collectible for goods sold, services performed, or money loaned. Also called accounts receivable.

**Receivables Turnover:** measurement of how effective a company is in collecting on its trade receivables.

**Receiver:** person appointed by the court to receive, take charge, and hold in trust property in litigation or bankruptcy until a legal decision is made as to its disposition.

**Receivership:** 1. court action whereby money or property is placed under control and administration of receiver is to be preserved for benefit of persons or creditors ultimately entitled to it. 2. procedure used to help a distressed debtor or to resolve dispute.

**Reclamation:** 1. legal action by titleholder to recover property from another’s possession. 2. process used to restore land to usable state.

**Record:** written account of act, transaction, or instrument drawn by proper legal authority that remains as permanent evidence.

**Recourse:** right of holder in due course to demand payment from anyone who endorsed instrument if original signer fails to pay.

**Recovery:** amount finally collected; amount of judgment.

**Reference Check:** contacting and interviewing business or professional associates of credit applicant to gain information about his or her creditworthiness.

**References:** names of trade suppliers or creditors provided by a customer to be used as a source of information about that customer.

**Refinance:** to reorganize existing debts by obtaining new debt that incorporates or pays off existing debts.

**Refunding:** replacement of an outstanding obligation with another obligation to extend the maturity date or to reduce the interest.

**Register:** book of factual public information, kept by a public official.

**Related Parties:** as defined under the BIA with respect to Preference issues.

**Release:** to discharge debt or give up claim against party from whom it is due by party to whom it is due.
**Release of Mortgage:** 1. act of releasing or relinquishing the claim against property established by a mortgage. 2. instrument by which such a release is effected.

**Remedy:** legal means by which right is enforced or violation of right is prevented or compensated.

**Rent Concession:** discount or other benefit offered by a landlord to induce the tenant to lease a property.

**Rental Value:** estimated amount of rent that could be obtained for the use and occupancy of a property.

**Rent:** periodic payments made by tenant to owner in return for leasing land, building space, or equipment.

**Reorganization:** 1. voluntary or court-ordered change in capital structure of corporation in which all assets of an old corporation are transferred to a newly formed corporation. 2. restructuring of business entity, whether in or out of bankruptcy.

**Replacement Reserve:** an accounting process whereby a concern identifies funds to meet the cost of replacement of an asset.

**Replacement Value:** is the estimated value of an asset determined by the amount it would cost to replace it with a like asset.

**Replevin:** legal action taken to recover possession of property unlawfully taken.

**Repossess:** action taken by creditor in which he or she takes possession of goods purchased under credit agreement or pledged as collateral if debtor defaults on terms of contract.

**Reproduction Value:** sum of money required to reproduce a building less an allowance for depreciation of that building.

**Rescind:** to void contract from its inception. Result is that parties are restored to relative positions before contract was made.

**Rescission:** agreement by parties to contract that effects cancellation of contract.

**Reserve:** in accounting, funds set aside for specific purpose. In mortgage lending, funds set aside for a particular purpose, usually to protect the security of outstanding mortgage loans.

**Reserve for Bad Debts:** valuation account established for accounts receivables that may prove uncollectible.

**Residence:** place where person legally lives part or full time.

**Residual Value:** the estimated recoverable amount of a depreciable asset as of the time of its removal from service.
**Restraint of Trade**: any action, by agreement or by combination, that tends to eliminate competition, artificially sets up prices, or results in monopoly.

**Restrictive Endorsement**: endorsement on negotiable instrument that limits any further negotiability, for example, “for deposit only” written on back of check.

**Restructured Loan**: loan on which a bank, for economic or legal reasons related to debtor’s financial difficulties, grants concession to debtor that would not be considered otherwise.

**Retailer**: company that sells its product directly to end-user.

**Retainage**: common in construction and construction lending it is a portion of an advance held back to meet any contingencies at a later time in the construction or awaiting the ultimate completion of the project.

**Retained Earnings**: cumulative earnings and losses of company that remain undistributed to shareholders.

**Retentions**: amounts withheld by customer from total billings until contractor has satisfactorily completed project.

**Retroactive**: 1. effective as of past date. 2. having reference to prior time.

**Retrofit**: modernization of existing property.

**Return**: rate of profit or earnings on sales or investment.

**Return Items/Returned Cheques**: cheques, drafts, or notes returned unpaid to originating bank by drawee bank so that originator can correct any errors or irregularities and may present items for collection again.

**Return on Assets: ROA**: a measure of a company’s profitability, equal to a fiscal year’s earnings divided by its total assets, expressed as a percentage.

**Return on Equity (ROE)**: a measure of a company’s profitability, equal to a fiscal year’s earnings divided by its net worth, expressed as a percentage.

**Revenue**: 1. income from sales, interest or dividends. 2. income from investment or wages.

**Reviewed or Review Engagement Financial Statements**: business financial statements that are reviewed by independent accountants through inquiries of management and performance of analytical procedures on financials to provide limited assurance that no material modifications are necessary for statements to conform to generally accepted accounting principles. Independent accountants do not express opinion on review statements.

**Revolving Charge**: credit type that allows borrower to become indebted up to an approved credit limit, with no fixed maturity date. Finance costs are assessed monthly on unpaid balance and periodic payments are required.
Revolving Credit: commitment under which funds can be borrowed, repaid, and re-borrowed during life of credit. Such credits have stated maturity date at which time borrower may have option of converting outstanding balance into term loan. See also Evergreen Revolving Credit.

Revolving Line of Credit: a credit facility against which a borrower may draw and repay as funds are needed or available over a period of time, provided that the balance outstanding does not exceed the line amount or the cap set by any availability formula.

Rider: schedule or amendment attached to a contract or document that becomes part of it.

Right of Redemption: see Equity of Redemption.

Right of Rescission: consumer’s right as prescribed by Consumer Protection Laws to rescind certain credit and mortgage contracts within a specified number of days without penalty.

Right of Setoff: right of financial institution to apply borrower’s funds on deposit to debt owed to the financial institution in event that payment on the debt is not made as agreed.

Risk Analysis: examination of the elements or sources of risk in a mortgage loan and of their effects separately and in combination.

Risk-Based Capital: level of capital that bank is required to maintain, determined by relating capital to risk by type of asset.

Risk Category: class or group into which related elements affecting mortgage risk are placed for purposes of convenience in analysis.

Risk Feature: item affecting mortgage risk.

Risk Rating: systematic process of analyzing borrower or mortgage risk that results in estimating, in relative terms, the soundness of individual transactions.

RMA: see Risk Management Association.

Risk Management Association (RMA): association of lending, credit, and risk management professionals. Originally, RMA was founded to facilitate the exchange of credit information. Today, RMA works continuously to improve practices of the financial services industry and to provide members with networking opportunities, training, research publications, and seminars.

R.O.G. Dating: payment term that uses date customer is in receipt of goods as effective sale date.

Royalty: compensation made to another for use of his or her work.
**S**

**Sale**: agreement or contract that transfers title of goods or property from one person or entity to another for consideration.

**Sale and Lease Back**: arrangement whereby company sells goods with intention to lease same goods from buyer.

**Sale on Approval**: purchase of goods conditioned on buyer approval of goods or retention of them beyond reasonable time.

**Sales Agreement**: written document by which a seller agrees to convey property to a buyer for a stipulated price and under specified conditions.

**Sales Concentration Risk**: the inherent risk to a concern of making the majority of sales to a small number of clients. Such a sales pattern exposes the concern to the risk that the defection of one, or a few clients, could cripple the business.

**Sales to Net Working Capital**: a ratio the expresses a concern’s balance sheet liquidity in relationship to its net sales for a year. It is calculated by dividing net sales by net working capital and is sometimes referred to as “Working Capital Turnover”.

**Salvage Value**: estimated worth of a depreciated asset at the end of its useful life.

**Satisfaction**: paying debt in full.

**Satisfaction of Judgment**: legal evidence that recorded judgment has been paid or settled and entered in court records.

**Satisfaction Piece**: legal evidence that debt has been paid in full or settled and that liens on collateral have been released.

**Schedule**: listing by account name or number of total sales, current sales, monies owing or paid, charge-backs, or credits. Also called aging schedule or trial balance.

**Scheduled Liability**: 1. in property insurance, listing of property—items or locations—covered. 2. in dishonesty insurance (fidelity bonding), listing of persons or positions covered.

**Scheduled Payment**: partial payments made at dates specified in credit agreement.

**Schedules**: in bankruptcy, lists showing debtor’s property—location, quantity, and money value; names and addresses of creditors and their class; or names and addresses of stockholders of each class.

**Scrap Value**: worth of asset that is going to be destroyed or used for its components.
Seasonability: The extent to which an industry is affected by normal changes in climate or calendar specific buying patterns.

Seasonal Loans: loans used to finance cyclical buildup of current (working capital) assets until those assets can be converted to cash.

Second Lien/Second Charge: lien or charge that can be honored only after first lien or first charge is satisfied.

Second Mortgage: mortgage secured by equity in property that is already subject to a first security interest. While under certain circumstances the second mortgage holder can enforce its rights, in liquidation, the second mortgage holder will receive no payment until the first mortgage holder is repaid in full.

Secondary Financing: See Junior Mortgage.

Secondary Reserves: assets of a bank that are convertible into cash on short notice by sale in the open market or by rediscount.

Secret Partner: partner in business whose interest in partnership is not publicly known.

Secured Creditor: lender or other person whose claim is supported by taking collateral.

Secured Loan: loan supported by borrower’s pledge of an asset such as marketable securities, accounts receivable, inventories, real estate, equipment, etc.

Secured Note: note that provides, upon default, certain pledged or mortgaged property that may be applied or sold in payment of debt.

Secured Party: 1. lender or other person to whom or in whose favor security interest has been given. Includes person to whom accounts or chattel paper have been sold. 2. trustee or agent representing holders of obligations issued under indenture of trust, equipment trust agreement, or like.

Securities: 1. documents that evidence debt or property pledged in fulfillment of obligation. 2. evidence of indebtedness or right to participate in earnings and distribution of corporate, trust, and other property.

Securitization: The process of aggregating similar instruments, such as loans or mortgages, into a negotiable security.

Securitization of Receivables: The process of aggregating accounts receivable into a negotiable security.

Security: guarantee or assets pledged that can be applied to loan or obligation.

Security Agreement: formally executed document that gives lender rights to property pledged by borrower in support of debt.
Security for Costs: prepayment of necessary legal expenses. Such charges, set by law, may be for commencement of suit and vary in different courts and jurisdictions. Some items for which prepaid costs may be requested are filing fees, process serving, premiums on court bonds, trial fees, posting security for costs, entering judgment, recording abstract of judgment, issue execution, and discovery actions after judgment.

Security Interest: right that lender or lienholder obtains to debtor’s goods as evidenced by security agreement.

Seller’s Market: economic condition in which demand is greater than supply and that typically causes prices to increase.

Sequestered Account: account that has been attached by court order with disbursements subject to court approval.

Service Business: firm that performs functions for its customers rather than sells goods.

Service Charge: payment demanded for services rendered.

Servicing: in mortgage financing, the performance by the mortgagee or an agent of the many services—billing, collection of interest and principal payments, re-inspections and reappraisals of the property, readjustment of the terms of the mortgage contract when necessary, tax filings, etc.—to be taken care of while the mortgage is held by the lending institution.

Setback: 1. distance from a lot line that by law, regulation, or deed restriction must be maintained free of coverage by any structure. 2. distance between the lot line and the building line.

Setoff: 1. defendant’s counter demand against plaintiff. 2. right of parties to contract to reduce debt owed to one party by netting it against amount owed by other. See also Right of Setoff.

Settle: 1. to mutually reach agreement for adjustment or liquidation of debt. 2. to negotiate payment of obligation or lawsuit for less than amount claimed.

Settlement: 1. adjustment or liquidation of accounts. 2. full and final payment of debt. See also Out-of-Court Settlement.

Shareholder: person or entity that legally owns stock in a corporation.

Sheriff’s Sale: court-ordered sale of property to satisfy judgment, mortgage, lien, or other outstanding debt against debtor.

Short-Term Liabilities: current debts that are due within one year.

Short-Term Loan: current debt obligation that matures within one year, evidenced by promissory note that spells out terms of agreement.

SIC: see Standard Industrial Classification.
Sight Draft: draft payable on demand when presented to drawee. See also Draft, Letter of Credit, and Time Draft.

Signature Loan: unsecured loan backed only by borrower’s signature on promissory note. No collateral is taken by lender. This loan is generally offered to individuals with good credit standing. Also called good faith loan or character loan.

Signature Verification: examination of signature on negotiable instrument to determine whether handwriting is genuine and whether person signing cheque is authorized to use account.

Simple Interest: interest calculated on outstanding principal amount of debt or investment only.

Single Proprietorship: ownership of company by one person.

Skip Tracing: process used to obtain information to locate debtor’s whereabouts in order to collect payment on debts. Sources used include other creditors, friends, relatives, neighbors, directories, credit bureaus, court records, and other informants or references.

Slander: oral defamation of another’s reputation.

Small Business Financing Program: Refer Canada Small Business Financing Program.

Smart Building: building featuring the most up-to-date communications and information processing equipment.

Soft Goods: non-durable consumer goods such as clothing and linen, having a short-term useful life.

Sold Out-of-Trust: event occurring in floor plan financing where a borrower sells inventory securing the financial institution’s loan and fails to promptly remit the proceeds to the financial institution in accordance with the loan agreement. Also referred to as Out of Trust (SOT).

Sole Owner: one with title to proprietorship.

Sole Proprietorship: a form of business organization where the individual and the business are not separate legal entities. The owner has unlimited liability for the actions and obligations of the business. When the owner dies, the business does not continue as it is not a separate legal entity.

Solvency: ability to pay one’s debts in usual and ordinary course of business as they mature.

SOT: See Sold Out of Trust

Special Assessment: charge levied against property by public authority to defray, in whole or in part, the cost of installation of public improvements from which the property presumably benefits.

Special Material: made-to-order material or work done to customer’s specifications that has no value to seller if order is canceled.
Special Mention Assets: as it relates to risk assessment of bank assets, assets that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of repayment prospects for asset or in institution’s credit position at some future date. Special mention assets are not adversely classified and do not expose institution to sufficient risk to warrant adverse classification.

Specific Coverage: property coverage on designated property or item. Contrasts with Blanket Coverage.

Specific identification: is the inventory valuation method that values the inventory based on the ability to specifically identify the asset. It is generally utilized in instances where inventory is of high value (as in jewelry) or serial numbered (as in automobiles). 

Specific Performance: court order directing party guilty of breach of contract to undertake complete performance of contractual obligation in instances in which damages would inadequately compensate injured party.

Speculation: investment made with hope of achieving large financial gain.

Speculator: one who makes risky investments for quick financial gain rather than long-term investment.

Speculative Builder: see Operative Builder.

Square Foot Cost: the cost or estimated cost of building a structure divided by its calculated floor area.

Stabilized Occupancy: optimum range of long-term occupancy that an income-producing real estate project is expected to achieve under competent management after space has been exposed for lease in the open market for a reasonable period of time at terms and conditions comparable to competitive offerings in the open market. Implicit in this definition is recognition that a level of occupancy has been achieved that will produce sufficient revenue net of any rental or other concessions to cover all typical property operating expenses, service a level of debt typical for the property type in its locale and return a market-based level of profit to the entrepreneur. See also Value Upon Stabilized Occupancy.

Stale or Stale-dated Cheque: negotiable draft that has been held too long to be honored for payment; considered stale-dated after 6 months.

Standard Industrial Classification (SIC): statistical classification standard underlying all establishment-based federal economic statistics classified by industry. SIC is used to promote comparability of establishment data describing various facets of the U.S. economy. Classification covers entire field of economic activities and defines industries in accordance with composition and structure of economy. It is revised periodically to reflect economy’s changing industrial organization. See also North American Industrial Classification System and NAICS.
**Standard Mortgage Clause:** a clause in an insurance policy that ensures that a lender’s right to coverage under the policy will not be affected or defeated by any act, neglect or default of the borrower.

**Standby Letter of Credit:** type of letter of credit issued by bank that may only be drawn on by payee if party that makes letter of credit (drawer) defaults or does not perform according to terms of specific contract or agreement. See also *Letter of Credit*.

**Standby Commitment:** commitment issued by a financial institution to finance a property, should the owner accept it.

**Statement:** 1. itemized summary and accounting of charges, payments, and balance outstanding at close of billing period. 2. financial report.

**Statement of Cash Flows:** financial statement that shows cash receipts and disbursements for given period.

**Statement of Changes in Owner’s Equity:** financial statement that reconciles changes in capital accounts (capital stock, paid in surplus, and retained earnings).

**Statute:** written law.

**Statute of Frauds:** law prohibiting filing of actions or suits against certain types of contracts unless the contracts are in writing.

**Statute of Limitations:** law that sets time frame for bringing action against another. Time frame varies according to nature of claim and jurisdiction.

**Stay:** act of arresting judicial proceeding by court order.

**Stipulation:** agreement between opposing attorneys in lawsuit, usually required to be in writing.

**Stock:** 1. merchandise or inventory on hand and available for sale. 2. certificate that indicates number of shares of ownership in corporation.

**Stock Power:** document executed in form of power of attorney by which owner of stock authorizes another party to sell or transfer stock.

**Stop-Payment Order:** instructions given by depositor to a financial institution to dishonor, or not make payment on, a certain check.

**Straight Amortization Plan:** an amortization plan that provides for the payment of a fixed amount of principal at specified intervals, with interest payable on the remaining balance of the loan.

**Straight-Line Recapture:** recovery of principal in equal amounts over the life of the loan.

**Straight Term Mortgage Loan:** mortgage loan granted for a fixed term of years, the entire loan becoming due at the end of that time.
**Strike Price**: the specified price of a stock on an option contract at which the contract may be exercised. Also called the “Exercise Price”.

**Subcontract**: contract between prime contractor and another contractor or supplier to perform specified work or to supply specified materials in accordance with plans and specifications for project.

**Subdivision**: division of a parcel of land into multiple building lots, streets, amenities, and utilities.

**Subject**: party on which credit information is requested.

**Subjective Value**: value that an individual may place on goods for his or her own purposes.

**Sub-limit**: specified, partial amount of credit facility that is designated for special use.

**Subordinated Debt**: debt that has a lower priority than that of other debt. It may be unsecured or have a claim on the same assets, but differ in priority. Also referred to as “Junior Debt”.

**Subordination**: 1. acknowledgment by a creditor in writing that the debt due from a specified debtor shall have a status inferior or subordinate to the debt that the debtor owes another creditor. 2. act of agreeing to take secondary position.

**Subpoena**: process to demand person to appear in court and give testimony.

**Subrogation**: substitution of one creditor for another so that substituted creditor succeeds to rights, remedies, or proceeds of claim.

**Subsidiary**: business entity owned or controlled by another organization.

**Summons**: formal notice served on defendant stating that action has been instituted against him or her and requiring defendant to appear in court to answer it.

**Super-Priority Claims**: are those claims that will take priority over a lender’s security in the event the business fails and be paid prior to amounts owing to the lender. They can include things like Government Withholding Taxes, including Unemployment Insurance Premiums, Canada Pension Plan Contributions and Income tax, among others. The ranking of priority claims depends on several things, including the jurisdiction of the business and the legislation under which the liquidation is being managed.

**Supplementary Proceedings**: statutory action requiring judgment debtor to appear in court to discover property against which action can be taken by creditor to enforce collection of judgment.

**Supplier**: business that sells goods, materials, or services to customers. Also called vendor.

**Surety**: individual who agrees, usually in writing, to be responsible for the performance of another on a contract, or for a certain debt or debts of another individual. An insurance, bond,
guaranty, or other security that protects a person, corporation, or legal entity in case of another’s default in the payment of a given obligation, proper performance of a given contract, malfeasance of office, etc.

**Surety Bond**: guaranty that payment or performance of some specific act will be completed under penalty or forfeiture of bond usually issued by a bonding company.

**Suretyship**: undertaking by person or entity to pay obligation of obligee in favor of principal when obligee defaults; such undertaking by individual is known as personal suretyship and by insurance company as corporate suretyship.

**Survey**: map prepared by a licensed surveyor identifying the boundaries of a property.

**Suspense File or Account**: group of accounts, records, or other items held temporarily until final disposition is determined.

**Swap**: financial derivative contract between two parties to exchange future payments based on either interest or currency. An interest rate swap is a contract which exchanges fixed-rate interest payments for floating-rate interest payments, or floating-rate interest payments on different bases (e.g. prime rate versus LIBOR), calculated on specific floating indices by reference to a notional principal amount for a specified term. A cross currency swap is a financial derivative or a contract between two parties to swap different currencies at one date or scheduled dates in the future (i.e. Canadian dollars versus U.S. dollars).

**Sweep Account**: type of cash management tool in which, when prearranged amount of cash accumulates in account, amount is automatically invested.

**Swindle**: 1. to obtain money or property by deceitful misrepresentation. 2. to cheat or fraudulently induce individual to give up his or her property willingly.

**Swing Factors**: Swing factors, measured by turnover ratios, are also called efficiency ratios and relate to how efficiently the company manages its accounts receivable (A/R days outstanding), inventory (Inventory days on hand), and accounts payable (A/P days outstanding). These swing factors bring the cash flow effect of the current section (working capital assets) of the balance sheet into the focal point of the credit analysis.

**Swing Loan**: see *Bridge Loan*.

**Syndicate**: temporary association of persons or firms formed to carry out business venture or project of mutual interest.

**Syndication**: financing whereby commercial or investment bankers agree to advance portion of funding. Syndicater acts as investment manager, collecting loan origination fee or commitment fee from borrower and arranging for sale to other banks in group. Typically, syndicater keeps only small portion of total financing. A syndicated loan differs from loan participation because syndicate members are known at outset to borrower. Syndication also separates lead bank from group of financial institutions that ultimately fund obligation.
Takeover: acquisition, seizure, control, or management of one business by another.

Tangible Assets: assets that can be weighed, measured, or counted, including cash, property, machinery, furnishings and buildings.

Tangible Leverage: the ratio between tangible net worth and total liabilities. It is calculated by subtracting all intangible assets from the net worth and dividing the answer into total liabilities.

Tangible Net Worth: Net Worth less any intangible assets. Intangible assets are those that in the eyes of the lender have no tangible value, e.g. Goodwill.

Tax: payments imposed by legislative authority for support of government and its functions.

Taxable Income: portion of individual’s or entity’s income that is subject to taxation.

Tax Avoidance: act of using legal deductions, exemptions, and tax code provisions to reduce taxes payable.

Tax Evasion: failure to report taxable income to avoid proper payment of taxes.

Tax Foreclosure: legal seizure and sale of property by authorized public official to satisfy unpaid taxes.

Tax Levy: legislative action by which tax is imposed.

Tax Lien: statutory claim by municipality against property of person owing taxes. Property may be sold to satisfy obligation or judgment filed against it.

Tax Sale: sale of property seized by governmental taxing body for nonpayment of taxes.

Tenancy in Common: two or more persons who hold title to land or other property in undivided ownership.

Tenant: one who holds or occupies real property owned by another party in accordance with a lease; a lessee.

Tenant Improvement Allowance: cash payment made by a landlord to a tenant to permit the tenant to complete improvements.

Tender: 1. unconditional offer of money or performance to satisfy claim. 2. offer to buy stock to take control of company.

Term Loan: fixed-term business loan with a maturity of more than one year and with defined periodic payments, providing borrower with working capital to acquire assets or inventory or to finance plant and equipment.

Terms: conditions and requirements as set forth in sales proposal, contract, or promissory note.
**Term Mortgage:** see *Straight Term Mortgage Loan*.

**Terms of Sale:** mutually agreed upon conditions for transfer of title or ownership of goods or property.

**Territory:** referring to the three Territories in Canada or any one of them – Nunavut, Northwest Territories and the Yukon.

**Testimony:** written or oral evidence given in court under oath.

**Third Party:** one who is not directly related to action between two parties but who may be affected by its outcome.

**Third-Party Claim:** demand made by person who is not party to action for delivery or possession of personal property, title to which is claimed by third party.

**Time Deposit:** interest-bearing funds deposited in a financial institution for a specified period of time such as certificates of deposit and savings accounts.

**Time Draft:** draft payable on fixed date or certain number of days after sight or date of draft. See also *Banker’s Acceptance, Draft, Letter of Credit, and Sight Draft*.

**Title:** document that evidences legal ownership and possession of property.

**Title Company:** business that as contracted researches specific property’s history through real estate records and issues policy to purchaser or lienholder guaranteeing that there are no known defects in title.

**Title Insurance:** insurance provided by a title insurance company or a title guaranty company that, for a fee, has searched the validity and completeness of title to a piece of property; and that, for an additional fee or premium, issues a policy insuring the present title holder (the purchaser) and policy holder against loss due to any defect in the title.

**Title Opinion:** a title opinion is prepared by an attorney and states that to the best of his or her knowledge there are no disputes over the ownership of the property. It is not the same as, nor is it a substitute for, a title insurance policy.

**Title Search:** to review history of property’s ownership and any judgments or liens filed against it.

**Tort:** violation of legal duty that results in injury or damage to another.

**Trade Acceptance:** draft, accepted by buyer, sent with shipment of goods, requiring customer to pay amount involved at specific date and place.

**Trade Credit:** accounts payable; credit extended from one company to another.

**Trade Debts:** liabilities due from one business to another for purchase of supplies, inventory, etc.
**Trade-In:** property accepted by seller as partial down payment on purchase of new item.

**Trade Information:** confidential exchange of payment history and credit information among suppliers.

**Trademark:** distinctive identifying mark, word, or logo of product or service; protected when registered with Canadian Intellectual Property Office.

**Trade Name:** name used by a company to identify itself in the course of business. Also known as *Trade Style* or *Fictitious Name*.

**Trade Payment Record:** summary of performance of company in meeting terms of its credit obligations.

**Trade References:** names of suppliers or business creditors with whom credit information on customer can be exchanged.

**Trading Assets:** the current assets used by a concern in carrying out its normal business. i.e. Accounts receivable and inventory. Also referred to as Operating Assets.

**Transaction Value:**

- Means: For loans or other extensions of credit, the amount of the loan or extension of credit;

- For sales, leases, purchases, and investments in or exchanges of real property, the market value of the real property interest involved; and,

- For the pooling of loans or interests in real property for resale or purchase, the amount of the loan or market value of the real property calculated with respect to each such loan or interest in real property.\(^4\)

**Treasury Workstation:** microcomputer-based information management system that allows corporate treasurer to automate daily balance reporting of collected balances, to invest idle funds in short-term money market, and to disburse funds to trade creditors. Overall aim is improvement in productivity and eventual integration of funds management and corporate accounting systems, such as order entry and invoicing.

**Trial Balance:** listing of all account balances from general ledger used in preparing financial statements.

**Triple Net:** lease of space requiring the tenant to pay taxes, utilities, and insurance in addition to base rent.

**Troubled Debt Restructure:** the renegotiation of a concern’s debt at a time when the concern is experiencing difficulty in complying with the existing terms thereof.

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\(^4\) Ibid.
Truck Jobber: wholesale merchant who sells and delivers products from truck inventory at time of sale. Also called Wagon Distributor.

Trust: right to real or personal property that is held by one for benefit of another.

Trust and Loan Companies Act: federal legislation regulating trust, loan or insurance companies as defined therein.

Trust Company: business that acts as fiduciary and agent handling trusts, estates, and guardianships for individuals and businesses.

Trustee: one who holds or is entrusted with management of property or funds for benefit of another.

Trustee in Bankruptcy: person appointed by court or elected by creditors to manage bankrupt property and carry out responsibilities of trust in proceedings.

Turnkey: something that is constructed, supplied, or installed and fully ready as intended.

UCA (Direct Method) Cash Flow Coverage Ratio: calculated in a “Direct Cash Flow Statement”, used in Uniform Credit Analysis (UCA), it is the ratio between “Net Cash Income” and “Total Debt Amortization”. i.e. ”Net Cash Income” divided by “Total Debt Amortization” (Current Maturities Long Term Debt Plus Capital Lease Operations.

UCA (Direct) Cash Flow Projection: a cash flow projection constructed in the format a direct cash flow is set out in the Uniform Credit Analysis program.

UCA Cash Flow Statement:
UCA Direct Cash Flow Format:
UCA Direct Cash Flow Statement: a Cash Flow Statement for a specific period generated in a format starting with Sales/Revenues, often referred to as a “Top Down” cash flow statement, as used in the Uniform Credit Analysis.

Ultra Vires: unauthorized acts taken by corporation beyond powers conferred on it by corporate charter.

Umbrella Policy: in liability insurance, policy that applies excess coverage to primary or underlying contract; provides large limits and broad coverage or may cover only primary basis risks not otherwise insured.

Unaudited Financial Statement: financial statement or report based on figures that have not been verified by a qualified Accountant.

Uncollected Funds: deposits not yet collected by a financial institution, such as checks that have not yet cleared.
**Uncollectible Accounts:** receivables or debts not capable of being settled or recovered.

**Underwriter:** 1. person who reviews application for insurance and decides whether or not to accept risk. 2. one who agrees to purchase entire issue of bonds or securities at end of certain period. 3. a financial institution that provides a commitment for the entire amount of a financing that is required, and takes the risk of being successful in selling it down to other financial institutions.

**Undivided Interest:** partial interest owned by two or more parties in the same property.

**Undue Influence:** improper or illegal pressure used to wrongfully take advantage of person or influence his or her actions or decisions.

**Unearned Discount:** term used to reflect a reduced price (from the face value of an invoice) taken by a buyer without the consent of the seller.

**Unearned Income:** income received in advance of being earned.

**Unencumbered Property:** property that is free and clear of assessments, liens, easements, and exceptions of all kinds. See also *Encumbrance*.

**Unenforceable Claim:** debt on which all collection efforts have failed.

**Unfair Competition:** any fraudulent or dishonest practice intended to harm or unfairly attract competitor’s customers.

**Uniform Standards of Appraisal Practice (USPAP):** are the appraisal standards issued by the Appraisal Institute of Canada.

**Unjust Enrichment:** doctrine whereby one is not allowed to profit inequitably at another’s expense.

**Unqualified Opinion of a Financial Statement:** the Auditor confirms that the Audit has been performed according to GAAP and the financial statements are prepared in accordance with GAAP.

**Unsatisfied Judgment:** recorded judgment that has not been released or discharged.

**Unsecured Creditor:** one who grants credit without taking collateral in support of it.

**Unsecured Loan:** loan made on strength of borrower’s general financial condition. Contrasts with *Secured Loan*.

**Unvested Options:** options to purchase stock issued but requiring a set passage of time or the performance of an action to become exercisable. i.e. vested.

**Upstream Funding:** funds borrowed by a subsidiary of a holding company for holding company’s use. Contrasts with *Downstream Funding*. 
Usury: the rate of interest that exceeds the legal limit allowed to be charged for the use of another’s money. Jurisdictional law establishes legal limit of interest rate for different types of loan transactions.

Vacancy: unrented space in a building or in a market.

Vacancy Ratio: used to describe the percentage of a leaseable property’s occupancy to total leaseable space calculated as unleased space divided by total leaseable space and expressed as x:y.

Valuable Consideration: see Consideration.

Valuation: 1. estimated or determined worth of something. 2. process of appraising or affixing value of something. See Appraisal.

Value As If Completed: hypothetical value of a property as if all proposed improvements, development, rehabilitation, modernization, remodeling or changes in use were accomplished on the appraisal date.

Value As Is: value of specific ownership rights to what physically exists and is legally permissible on an identified parcel of real estate as of the date an appraisal is written or the subject property was last inspected.

Value Received: phrase used in bill of exchange or promissory note to denote that lawful consideration has been given.

Value to a Single Purchaser: price as of a specified date that a single purchaser could be expected to pay for a real estate project in which a portion of the overall rights in realty are expected to be sold to individual end-users over time. It implies that an informed purchaser would pay no more for a project at a specific point in time than the price at which he could acquire the property and cover all remaining direct or indirect costs expected to be incurred before sellout of all remaining units or lots. Costs expected to be incurred in the achievement of sellout may include, but are not necessarily limited to, all remaining costs associated with completing construction or development; all anticipated costs associated with marketing individual units or lots and maintaining the property during the absorption period; the cost of mortgage and equity capital expected to be incurred, plus a market-based level of entrepreneurial profit.

Value Upon Completion: prospective value of the expected physical and legal position of an identified parcel of real estate on the date when any development, rehabilitation, modernization, remodeling or change in use has been physically accomplished. It is a prospective value estimate predicated upon known or knowable data as well as the expectations of typically informed market participants as perceived on the date the appraisal is written.
**Value Upon Stabilized Occupancy:** prospective market value of the expected physical and legal condition of an identified parcel of real estate on the date when any development, rehabilitation, modernization, remodeling or change in use has been physically accomplished and the property has attained its expected level of long-term occupancy. It contemplates a value estimate of the total ownership rights to the expected physical and legal condition of an identified parcel of real estate. It is a prospective value estimate predicated upon known or knowable data as well as the expectations of typically informed market participants as perceived on the date the appraisal is written. It reflects: 1) the highest and best use of the expected physical and legal condition of the identified property rights on the prospective date of the value estimate; 2) the long-term economic feasibility of the identified property as it will physically and legally exist on the prospective date of the value estimate.

**Variable-Interest Rate:** interest rate that fluctuates with changes in an identified base rate or index.

**Vendor:** trade supplier or service provider.

**Vendor Financing:** financing of plant or equipment offered by the vendor or its captive financing company to a qualified purchaser. Frequently extended on preferential terms and conditions.

**Venture Capital:** capital invested or available for investment in the ownership element of a new enterprise.

**Verdict:** formal decision of judge or jury on matter submitted in trial.

**Verification:** 1. affidavit or statement under oath swearing to truth or accuracy of written document. 2. in accounting, confirmation of entries in books of account.

**Vertical Interest:** right to use or occupy the air space above a property. Also known as an air lease or air rights.

**Vest:** 1. to give immediate transfer of title to property. 2. to obtain absolute ownership.

**Void:** having no legal force.

**Voidable Contract:** contract that is nullified as to party who committed invalid act but not with respect to other party, unless he or she agrees to treat it as such.

**Voluntary Bankruptcy:** bankruptcy initiated by debtor petitioning court to be declared bankrupt.

**Voucher:** 1. statement itemizing payment or receipt of money. 2. detachable portion of check that describes purpose for which check was issued.
**Wage Assignment:** agreement by borrower that permits creditor to collect certain portion of borrower’s wages from employer in the event of a default.

**Wage Garnishment:** court order requiring that percentage of debtor’s earnings be withheld by employer and paid directly to creditor.

**Waiver:** intentional or voluntary relinquishing of known legal right.

**Warehouse Loans:** loans made against warehouse receipts that are evidence of collateral for material stored in public warehouse.

**Warehouse Receipt:** receipt issued by person engaged in business of storing goods for hire. It is document of title that gives evidence that person in possession of warehouse receipt is entitled to receive, hold, and dispose of document and goods it covers. Warehouse receipt in turn obligates warehouser to keep goods safely and to redeliver them upon surrender of receipt, properly endorsed, and payment of storage charges.

**Warrant:** a certificate commonly issued with a bond, preferred stock, or a credit agreement, entitling the holder to purchase common stock at a set price, at any time in the future within the terms of the certificate. The price is usually set above the stock price at the time of issue, on the assumption that the stock will rise in price and the holder will then be able to purchase the stock at below market and profit from the price differential. If the stock price does not rise, then the warrant will expire unused. Warrants are frequently listed on option exchanges and traded independently of the security with which it was issued. Sometimes referred to as a “Subscription Warrant”.

**Warranty Deed:** deed containing warranties as to the condition of title from the grantor to the grantee.

**Waste:** willful damage to or destruction of property.

**Weighted average cost:** is the inventory valuation method utilized when several batches of unidentifiable product are purchased throughout the year. For example, if twelve orders of identical candles are brought into inventory in a year, the amount expensed to COGS would be the average price, and the inventory remaining would reflect the average price of the unsold items.

**Whole Account Basis:** when margining accounts receivable, the practice of eliminating the entire account if any amount is due beyond a determined acceptable date.

**Wholesale Value:** a misnomer; see *Value to a Single Purchaser*.

**Wholesaler:** company whose primary function is as intermediary between manufacturer of goods and retailer or other wholesalers.

**Will:** legal declaration by person making disposition of property, effective only after death.

**Windfall Profit:** large, unexpected return or income.
Without Exception: see *Free and Clear*.

Without Prejudice: legal term used in offer, motion, or suit to indicate that parties’ rights or privileges involved remain intact and to allow new suit to be brought on same cause of action.

Without Recourse: term used in endorsing negotiable instrument excluding endorser from responsibility should obligation not be paid.

With Prejudice: legal term used for dismissal of lawsuit that bars any future action and that, if prosecuted to final adjudication, would have been adverse to plaintiff.

With Recourse: endorsement of negotiable instrument on which endorser remains responsible should obligation not be paid.

Working Capital: 1. current assets less current liabilities, used as measure of firm’s liquidity. 2. funds available to finance company’s current operations.

Working Papers: information or schedules used by accountant in preparing financial reports.

Work in Process (WIP): goods in act of being manufactured, but not yet finished and ready for sale, comprising portion of inventory.

Workout: problem loan on which financial institution is working closely with borrower for repayment, restructuring, or modification because of noncompliance with loan covenants.

Wrap-Around Mortgage: second or junior mortgage with a face value of both the amount it secures and the balance due under the first mortgage. Covenant contained within second mortgage used to induce sellers of commercial properties to sell to buyer who has small down payment, normally when interest rates are high.

Writ of Execution: writ issued by court ordering sheriff to attach debtor’s property to enforce payment of judgment.

Write-Down: partial reduction in book value of asset as result of obsolescence or depreciation.

Write-Off: see *Charge-off*.

Writ of Attachment: court order directing sheriff to seize property of debtor held as security for satisfaction of judgment.

Y

Yield: rate of return on investment.
Z

**Zero Balance Account:** a checking account (subordinate account) used for disbursing or collecting funds in which no balances are maintained. At the end of the processing day, funds are transferred from a master account or concentration account to cover activity in the subordinate account.

**Zero Lot Line:** placing of a structure on a site so that one or more sides are directly on the lot line with no setback.

**Zoning:** process of establishing by legislation certain restrictions on the use to which property may be put.

**Zoning Ordinance:** municipal regulation dividing land into districts and prescribing structural, architectural, and nature of use of buildings within these districts.