

# Body of Knowledge – Canadian Edition



# 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.

<b>EMERGING STAGE CHARACTERISTICS</b>		
<b>LIFE CYCLE STAGE</b>	<b>POSSIBLE STRENGTHS</b>	<b>RISKS</b>
<p><b>Emerging:</b> Products are developed and presented to potential consumers. It is uncertain at this point if there will be acceptance of the new product/industry.</p>	<ul style="list-style-type: none"> <li>• High sales due to product introduction and unique positioning</li> <li>• Little competition</li> <li>• High prices and gross margins (as result of little competition)</li> <li>• Registration of patents and intellectual property rights to create barriers of entry to competitors</li> <li>• Able to develop brand loyalty</li> </ul>	<ul style="list-style-type: none"> <li>• Failure-the failure rate for new products is high -some gain acceptance only after modification from their original form</li> <li>• Production capacity –either under or over capacity as demand varies substantially from projections</li> <li>• Low net margins because of high R&amp;D and marketing costs</li> <li>• Initial mismatch of cash flows</li> <li>• Initial product quality may be poor dictating the need for expensive changes to the product design or formulation</li> <li>• Winning marketing strategy prior to implementation not apparent</li> </ul>

**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

# 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 market place?

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?
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# 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 great 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.

# 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:

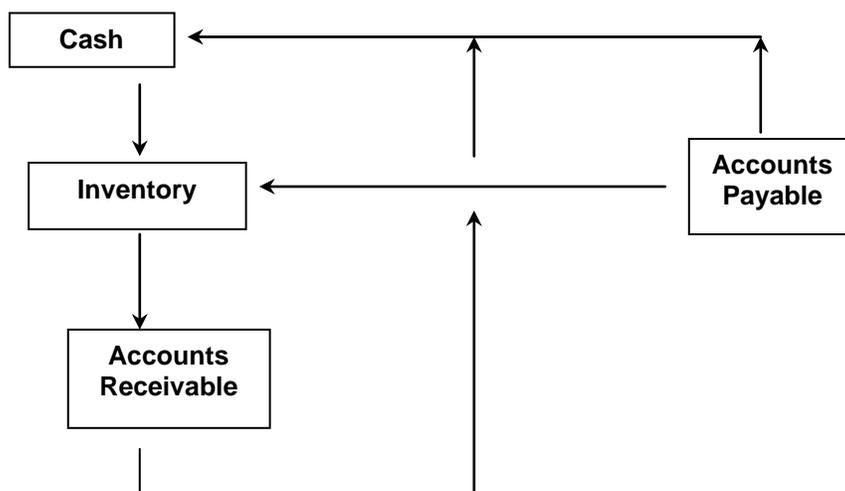
- Cash Cycle Analysis
- Cash Flow Statement Analysis
- Cash Flow Methods
  - Direct
  - Indirect
- Alternative Cash Flow Measures
  - EBITDA or Earnings before interest, taxes, depreciation and amortization
  - Free Cash Flow
- Comparing Cash Flow to Industry Peers
- Discovering Borrowing Causes and 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.

## 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.

$$\begin{array}{r} \text{AVERAGE DAYS' SALES IN RECEIVABLES} \\ + \quad \text{AVERAGE DAYS' COGS IN INVENTORY} \end{array}$$

- 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*:

### Days Outstanding

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Industry	NAICS	DAYS			
		A/R	Inventory	A/P	Cash Cycle
Restaurants	71111	1	+13	-25	-11
Airlines	481111 481112	30	N/A	-N/A	30
Hotels	72111, 72112	30	N/A	-N/A	30
Supermarkets	44511, 44512	1	+23	-13	11
Manufacturers (Computers)	334111	69	+99	-45	123
Wholesalers (Computers)	42143	36	+57	-38	55
Retails (Computers)	44312	34	+59	-32	61
Computer Processing Services	51421	+51	+N/A	-N/A	51

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.

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.

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.

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 overvaluing 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?

# 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.

**Average Daily Balance:** average amount of money that depositor keeps on deposit when calculated on daily basis.

## B

**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).

**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.

**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.

**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.

**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.

## F

**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