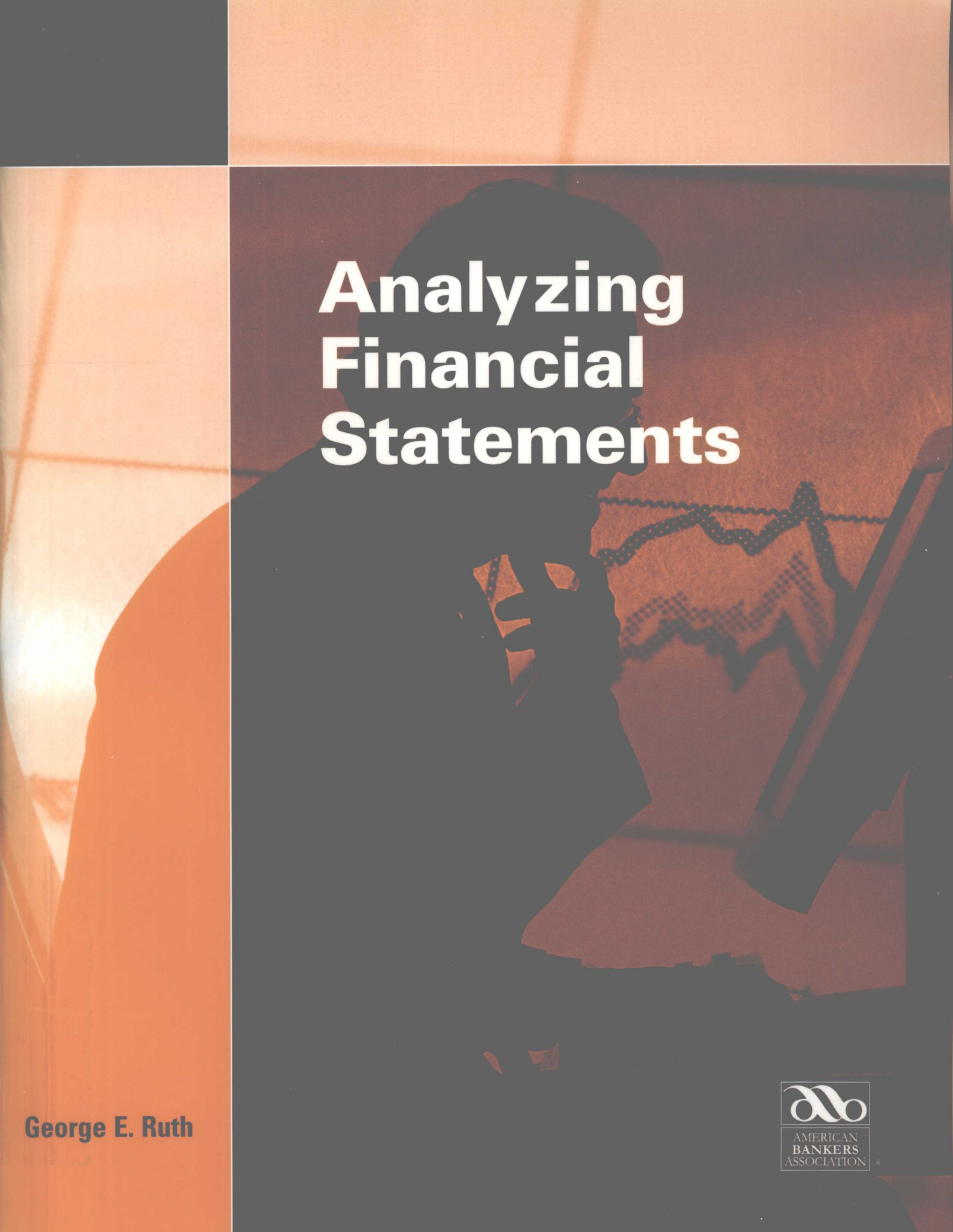


The background of the cover features a dark silhouette of a person's head and shoulders, facing right. They appear to be holding and reading a document. Overlaid on the right side of the silhouette is a line graph with a jagged, fluctuating line. The entire cover is set against a warm, orange-toned background with a subtle grid pattern.

Analyzing Financial Statements

George E. Ruth



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PREFACE

One of my favorite sayings is “Numbers talk and banker’s need to listen.” The purpose of *Analyzing Financial Statements* is to provide commercial lenders with the knowledge and skills they need in order to analyze and interpret financial information. The goal of this textbook is to emphasize “listening” to the interpretation, not merely calculating the numbers. A number of practical exercises are located at the end of each chapter.

The primary audience of this text includes trainees in credit training programs, small business lenders, loan review staff, and those who need to understand the analysis of business financial statements as part of their job. Although most banks now use computer programs to spread financial information and make calculations, bankers need to understand how the numbers came together and what they mean. To accomplish this, a lender must

- understand the source of the information,
- determine the quality of the financial statement received,
- know the legal structure and type of business organization,
- be able to interpret the data, and
- apply this understanding to make a good credit decision.

Turner Electronic Corporation and Designs by Dezine, Inc., fictitious companies, are used throughout the textbook to help students learn the analysis process. The analysis process begins with an understanding of the types of financial information the lender may receive, the components of the financial statements, and other management reports. The process continues with an understanding of the various forms of business organization and legal structure, types of loan structures, and competing and complementing sources of financing. Whether a business is a manufacturer, wholesaler, retailer, service company, or agricultural, its business organization and legal structure affect its income statement and balance sheet.

Nest in the process is the analysis of the income statement. The income statement is analyzed first because of its impact on the balance sheet. While analyzing an income statement, a lender must consider sales, cost of goods sold, fixed and variable expenses, and the net profit margin. In addition, a lender should consider break-even and operating leverage, concepts that are important in income statement analysis.

With an understanding of the income statement, the balance sheet is analyzed next. The various balance sheet accounts are classified as assets, liabilities, or net worth. Accountants and bankers classify these accounts differently. This textbook clarifies how bankers classify each account.

Next ratios are calculated. Ratios are categorized as liquidity, financial leverage, coverage, or profit in nature. The textbook explains how to calculate each ratio and then what the ratio means. Because cash, and only cash, repays loans, two chapters are devoted to cash flow. The first chapter focuses on the accountants, lender prepared direct method, abbreviated method, and traditional cash flow methods used to analyze business financial statements. The second chapter focuses on personal cash flow and financial statements.

The final two chapters explain cash budget and pro forma financial statements. Again, practical application exercises are used to demonstrate these concepts.

The new addition features a *Master Case Book* that includes blank forms you may want to use. A summary of business and personal financial statement components, listing accounts as current and noncurrent, is provided to give consistent account classifications. A summary of various ratios, how to calculate them, and what they mean is also provided. Blank forms to calculate a cash budget and personal cash flow are also provided.

Analyzing financial statements is a process in which a systematic procedure must be followed step-by-step in order to assess and monitor credit risk. With this in mind, the new edition of *Analyzing Financial Statements* was expanded to include:

- how to calculate break-even
- emerging technologies
- how to calculate and interpret traditional and global cash flow, and
- new cases and exercises to apply what you have learned.

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1

FINANCIAL STATEMENT ANALYSIS: AN OVERVIEW

LEARNING OBJECTIVES

After studying *Financial Statement Analysis: An Overview*, you will be able to

- define financial statement analysis,
- explain technical versus interpretive aspects of credit analysis,
- explain differences between accrual and cash accounting,
- identify and describe types of internally and externally prepared financial statements,
- identify and describe common types of internally prepared management reports,
- understand limitations of financial statement analysis, and
- define key terms that appear in **bold** type in the text.