USING FINANCIAL STATEMENTS TO PINPOINT PROBLEMS

The best cure for potential financial problems is fast action. Financial statements often tell a story that will enable you to act in time, *if* you periodically review your financial statements and if you understand what the figures are telling you. Here are some things to look for when analyzing your financial statements.

1. **Deterioration in cash position** -This may be a drop in dollar levels or in the percentage of cash to total assets. It is often accompanied by marked changes in deposit activity, including overdrafts, draws on uncollected funds, more frequent deposits, deposits of smaller value checks, and declining average monthly balances.

2. **Slowdown in the receivables collection period** -A slowdown points to an owner who has become liberal with credit policies or gotten lax in collecting from his credit customers.

3. **Changes in credit and sales philosophies** -Installments sales may have replaced stricter credit terms. Finance or lease arrangements may have been allowed; these may seem attractive, but small firms should avoid them.

4. **Sharp increases in the dollar amounts of accounts receivable or as a percentage of total assets** -A request for a receivables aging may show substantial past due accounts with a few customers, or worse, with a single customer. Where such customers are of questionable financial strength, the risk becomes undesirably high.

5. **Noticeably rising inventory levels, in dollar amount or as a percentage of total assets** -These increases, often supported by suppliers, can be very risky .They may also be related to the borrower's reluctance to liquidate excessive or obsolete goods at a reduced price. Too many businesspeople sacrifice liquidity trying to maintain established gross profit margins.

6. **Slowdown in inventory turnover** -This may reveal overbuying or some other imbalance in the company's purchasing policies. Often it indicates that slow-moving items are not being dealt with properly. Determining how long items have been in inventory may help you determine the reason for the slowdown in inventory turnover.

7. **Decline in current assets as a percent of total assets** -Businesses have to rely upon the conversion of working assets to obtain funds to pay creditors. When funds become concentrated in less-liquid assets, another source of funds to pay debts may have to be found.

8. **Marked changes in the trading asset mix -**While a shift from inventory to receivables is an improvement in liquidity, the receivables include unrealized profits until they are collected. As the concentration swings back into inventory, the higher inventory level (until it's sold) is a cost disguised as an asset. In other words, it's an investment.

9. **Declining concentrations in fixed assets** -Funds needed to purchase fixed assets may be being used for other things. This creates problems in times of rising costs when future replacement, renovation, and remodeling may seriously drain cash or necessitate large amounts of long -term debt.

10. **Rising concentrations of fixed assets** -This can be a serious problem when achieved at the expense of other asset needs. Levels well above industry norms are an added indicator of potential trouble. Also significant is the related rise in funded debt to support such acquisitions, especially when the company has committed a sizable portion of its future earnings to pay for them

11. **Revaluation of assets for statement purposes** -Most commonly seen in the area of fixed assets. this is justified only to the extent that it reflects more realistic values. It creates no new values and cannot be justified as an inducement to a banker to increase loans.

12. **Heavy liens on assets** -The extent to which preferred creditors have claims on various assets is a key to what may be left for general creditors. Evidence of second and third mortgage holders is a sign of greater-than-aver risk. Most borrowers are reluctant to use this source unless more conventional sources have been exhausted.

13. **Concentrations in non-current assets other than fixed assets** -Two situations require special consideration. The first occurs when a company invests in affiliates or subsidiaries, and the bank can obtain no insight into the real values of those companies. The second involves the tendency to drain working assets to build an investment portfolio of "marketable" securities. This is especially dangerous when current creditors are increasingly supporting working asset purchases.

14. **High concentration of assets in intangible values** -Since most prudent credit analysts disregard intangibles in computing a company's net worth, it is often difficult to assess the value of intangible assets since they shrink or vanish much faster and more extensively in liquidation than do hard assets.

15. **Disproportionate rise in current debt -**The element of risk is always greater when the rise is concentrated in trade debt or the rise is in "friendly debt" (monies due officers and stockholders} or when there is no corresponding increase in the levels of assets.

16. **Substantial increases in long-term debt** -This is serious when repayment must depend upon a flow of funds that represent the bulk of anticipated earnings over many years. A less-than-satisfactory historical earnings record makes such commitments even more dangerous.

17. **High debt to capital relationship** (even more serious when the current ratio is low) -Poorly capitalized companies generally show poor working capital conditions. Even when there is adequate working capital, generally it is the result of heavy term-debt funding. Future earnings, normally a source of working capital growth, might well be needed exclusively for debt service

18. **Major gap between gross and net sales** -Such a gap represents a rising level of returns and allowances which could be caused by lower quality or inferior product lines. Customer dissatisfaction can take the form of cancellations, complaints, and loss of goodwill. Lower gross sales levels usually occur on a delayed basis. This gap can also affect receivable quality and quantity as customers return products or refuse to pay for them.

19. **Rising cost percentages** -A 1% cost increase on $1 million in sales represents a decrease of $10,000 in pretax profit. When the cost increase comes in cost of goods sold, it may reflect the borrower's inability or unwillingness to pass higher costs along to customers. When it appears in the operating area, it may reflect a loss of control over some segment of general, selling, or administrative expenses

20. **Rising sales and falling profits -The** decrease in profits may be in dollars, profit margins, or both. Unless the company is heavily capitalized, this will ultimately be reflected in an increasing reliance upon debt.

21. **Rising levels of bad debt losses** -Unless bad debt losses remain constant as a percent of sales, it signals deterioration in customer quality, usually with a slowdown in the average collection period. Check loss reserve levels to determine whether they have been increased to accommodate the higher loss risks involved.

22. **Rising level of total assets in relation to sales** -No one questions the fact that when you do more business, you normally require a higher level of inventory, carry greater receivables, and need more fixed assets. The time to raise questions is when assets rise much faster than sales growth warrants. If they do, it's usually the creditors who end up financing the higher asset levels simply because the business is not paying its way with higher profits.

23. **Rising level of total assets in relation to profits** -The real investment of any business is represented by its assets rather than its capital. Even if a portion of these assets is debt supported, the fact remains that the company is obligated to pay those debts. The assets exist solely to add to earnings; it is a sign of failing performance when they earn increasingly less in relation to their size.

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