Analyzing Cash Flows

April 2013
Overview

• Introductions
• Importance of cash flow in underwriting decisions
• Key attributes to calculating cash flow
• Where to obtain information to calculate cash flows
• Considerations in analyzing cash flows
• Hot topics and common pitfalls
• Key takeaways and final thoughts
Importance of Cash Flow in Underwriting Decisions

- One of the most significant items to consider when making lending decisions
  - Originations
  - Renewals
  - Monitoring
- Typically a significant factor within the bank’s risk rating matrix
- Typically a significant factor in the terms of the loan (interest rate, maturity date, payment schedule, etc.)
Key Attributes in Calculating Cash Flows

- Business cash flows
  - Net income from operations
  - Add back depreciation, amortization, taxes (C Corp) and interest
  - Subtract any distributions or dividend payments
  - Add back/deduct other miscellaneous items
- Equals cash flows available to service debt
- Debt service coverage ratio =
  - Cash flow available to service debt
  - Annual debt payments (principal and interest)
Key Attributes in Calculating Cash Flows

- Personal cash flows
  - Adjusted gross income
  - Less taxes paid
  - Less living expenses
  - Add back/deduct other miscellaneous expenses
  - Equals cash flow available to service debt
- Debt service coverage ratio =
  - Cash flow available to service debt
  - Annual debt payments (principal and interest)
Key Attributes in Calculating Cash Flows

- Global cash flows
  - Business cash flows plus personal cash flows
  - Are business cash flows also included in personal cash flow calculations (Schedules C, D, and E considerations)?
  - Important to also consider business, personal, and global individually in lending decisions
Where to Obtain Information to Calculate Cash Flows

- Audited and reviewed financial statements
- Compilations – disclosure and nondisclosure
- Tax returns
- Internal financial statements
- Personal financial statements
- Credit reports
- Projections
- Deposit account activity
Audited and Reviewed Financial Statements

• Reading of opinion letter
• Footnotes
• Cash flow statement
  – Indirect cash flow statement – reports changes in assets and liabilities from operating activity
  – Direct cash flow statements – reports cash receipts and cash disbursements from operating activity
  – Difference between EBITDA (earnings before interest, taxes, depreciation, and amortization) versus cash flow statement
• Commitments and contingencies
Example of Audit Opinion Letter

INDEPENDENT AUDITORS’ REPORT

February 19, 2013

Board of Directors and Shareholders
ABC Corporation, Inc. and Subsidiaries
Saginaw, Michigan

We have audited the accompanying consolidated financial statements of ABC Corporation, Inc. and Subsidiaries (the “Company”), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income, shareholders’ equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors’ Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on auditor judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company’s preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Corporation, Inc. and Subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.
Example of Footnotes
Example of Cash Flow Statement - Indirect Method
Cash Flow Statement – Indirect Method

• Key items or trends to consider
  – Are operating cash flows positive? Are operations being funded through debt or equity transactions?
  – Review and consider gains or losses on sales of fixed assets, investments, impairment of other assets, bad debts, etc.
  – Investing activities – key in understanding purchases of capital assets
  – Financing activities – key in understanding equity investments/distributions and issuances / repayment of debt (including shareholder debt or other subordinated debt)
Example of Commitment or Contingency Footnote
Commitments and Contingencies

• Key items or trends to consider
  – Litigation – pending or threatened
  – Asset acquisitions
  – Purchase and construction commitments
  – Product liabilities
  – Environmental matters
  – Employment agreements
  – Self insurance
  – Leases – capital or operating

• Future cash flow implications!
Disclosure and Nondisclosure Compilations

- Cost / benefit considerations (footnotes and cash flow statements)
- Accounting policies (including revenue recognition and accrual basis)
- Use of estimates
- Debt footnote (terms, maturity schedules, covenants, etc.)
- Commitments and contingencies
- Related party transactions
- Subsequent events
Tax Returns

- Commonly used to determine cash flow
- Type of entity will determine where and how to find information to calculate cash flows
  - Sole Proprietorship
  - Partnership
  - “C” Corporation
  - “S” Corporation
  - Limited Liability Company (LLC)
  - Professional Corporation (PC)
Sole Proprietorship

- Sole proprietorship is the most basic and usually the simplest form of business organization. In most cases, the owner holds title to property, conducts business for a profit and is personally liable for all obligations of that business.
- Unlimited liability (i.e., the personal assets of the owner can be seized to satisfy business debt)
- Limited capital and management resources
- No balance sheet information
Sole Proprietorship

• Tax implications
  – Pass-through income
  – Schedule C or e-filed with owner’s personal Form 1040
### Tax Return Example - Form 1040

**Form 1040**

- **U.S. Individual Income Tax Return**
- **2012**, ending **20**
- **Social security number**
- **Spouse's social security number**

#### Filing Status

- Single
- Married filing jointly (even if only one had income)
- Married filing separately
- Head of household (with qualifying person)

#### Exemptions

- Qualifying widower(s) with dependent child
- Yourself or someone who can claim you as a dependent, do not check box 6a
- Spouse

#### Income

- Wages, salaries, tips, etc. Attach Form(s) W-2
- Taxable interest. Attach Schedule B if required
- Tax-exempt interest. Do not include on line 6a
- Ordinary dividends. Attach Schedule B if required
- Qualifying widower(s) with dependent child
- Taxable refunds, credits, or offsets of state and local income taxes
- Alimony received
- Business income or (loss). Attach Schedule C or C-EZ
- Capital gain or (loss). Attach Schedule D if required. If not required, check here □
- Other gains or (losses). Attach Form 4797
- IRA distributions
- Social security benefits
- Other income. List type and amount

#### Adjusted Gross Income

- Educator expenses
- Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2565 or 2565-EZ
- Health savings account deduction. Attach Form 8889
- Moving expenses. Attach Form 3903
- Deductible part of self-employment tax. Attach Schedule SE
- Self-employed SEP, SIMPLE, and qualified plans
- Self-employed health insurance deduction
- Penalty on early withdrawal of savings
- Alimony paid
- IRA deduction
- Student loan interest deduction
- Tuition and fees. Attach Form 8863
- Domestic production activities deduction. Attach Form 8903
- Add lines 23 through 35
- Subtract line 35 from line 22. This is your adjusted gross income

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.**

Cat. No. 11521B

Form 1040 (2012)
**Tax Return Example – Schedule C**

**SCHEDULE C (Form 1040)**

**Profit or Loss From Business**

[For information on Schedule C and its instructions, go to www.irs.gov/schedulec.]

**Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.**

**A** Principal business or profession, including product or service (see instructions)

**B** Enter code from instructions

**C** Business name. If no separate business name, leave blank.

**D** Employer ID number (EIN), foreign employer identification number (FEIN)

**E** Business address (including suite or room no.)

**F** Accounting method: (☐) Cash (☐) Accrual (☐) Other (specify)

**G** Did you “materially participate” in the operation of this business during 2012? If “No,” see instructions for limit on losses.

**H** If you started or acquired this business during 2012, check here.

**I** Did you make any payments in 2012 that would require you to file Form(s) 1099? (see instructions)

**J** If “Yes,” did you or will you file required Forms 1099?

### Part I: Income

1. Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the “statutory employee” box on that form was checked

2.

3.

4.

5.

6.

7. Gross income. Add lines 5 and 6

### Part II: Expenses

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>18</td>
</tr>
<tr>
<td>Car and truck expenses (see instructions)</td>
<td>9</td>
</tr>
<tr>
<td>Commissions and fees</td>
<td>10</td>
</tr>
<tr>
<td>Contract labor (see instructions)</td>
<td>11</td>
</tr>
<tr>
<td>Depreciation</td>
<td>12</td>
</tr>
<tr>
<td>Depreciation and section 179 expense deduction (not included in Part II) (see instructions)</td>
<td>13</td>
</tr>
<tr>
<td>Employee benefit programs (other than on line 19)</td>
<td>14</td>
</tr>
<tr>
<td>Insurance (other than health)</td>
<td>15</td>
</tr>
<tr>
<td>Interest</td>
<td>16</td>
</tr>
<tr>
<td>Mortgage (paid to banks, etc)</td>
<td>16a</td>
</tr>
<tr>
<td>Other</td>
<td>16b</td>
</tr>
<tr>
<td>Total</td>
<td>17</td>
</tr>
</tbody>
</table>

**Office expense (see instructions)**

**Pension and profit-sharing plans**

**Rent or lease (see instructions)**

**Supplies (not included in Part II)**

**Taxes and licenses**

**Travel, meals, and entertainment**

**a** Travel

**b** Deductible meals and entertainment (see instructions)

**24b**

**25**

**26**

**27a**

**27a**

**28**

**29**

**30**

**31**

**32**

**33**

For Paperwork Reduction Act Notice, see your tax return instructions.
**Tax Return Example – Schedule E**

---

### Schedule E (Form 1040)

**Supplemental Income and Loss**

- **From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.**

#### Part I

**Income or Loss From Rental Real Estate and Royalties**

- **Note.** If you are in the business of renting personal property, use Schedule C or E-Z (see instructions). If you are an individual, report rental income or loss from Schedule E.

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Physical address of each property (street, city, state, ZIP code)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Type of Property (from list below)</td>
<td>2</td>
<td>For each rental real estate property listed above, report the number of tax rental and personal use days. Check the QW box only if you meet the requirements to file as a qualified joint venture. See instructions.</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Rents received</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Royalties received</td>
<td>4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Expenses:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Advertising</td>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Auto and travel (see instructions)</td>
<td>6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Cleaning and maintenance</td>
<td>7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Commissions</td>
<td>8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Insurance</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Legal and other professional fees</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Management fees</td>
<td>11</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Mortgage interest paid to banks, etc. (see instructions)</td>
<td>12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Other interest</td>
<td>13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Repairs</td>
<td>14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Supplies</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Taxes</td>
<td>16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Utilities</td>
<td>17</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Depreciation expense or depletion</td>
<td>18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Other (see instructions)</td>
<td>19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Total expenses. Add lines 5 through 19</td>
<td>20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Subtract line 20 from line 9 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 4562.</td>
<td></td>
<td>21</td>
<td></td>
</tr>
</tbody>
</table>

**22. Deductible rental real estate loss after limitation, if any, on Form 4562 (see instructions)**

---

**For Paperwork Reduction Act Notice, see your tax return instructions.**

Cat. No. 115411

---

**Rehmann**

Business wisdom delivered.
General Partnership

• General partnership is composed of two or more partners to carry on a trade or business
• Additional source of capital
• Personal liability (i.e., a general partner is liable for all partnership liabilities)
• Tax return implications: Files 2 tax forms
  – Form 1065
  – Form 1040
Tax Return Example – Form 1065
**Tax Return Example Schedule K**

### Schedule K-1
**For calendar year (2012), or tax year beginning [ ] 2012 ending [ ] 20[2]**

#### Part I Information About the Partnership
- **A** Partnership's employer identification number
- **B** Partnership's name, address, city, state, and ZIP code
- **C** IRS Center where partnership filed return
- **D** Check if this is a publicly traded partnership (FTP)

#### Part II Information About the Partner
- **E** Partner's identifying number
- **F** Partner's name, address, city, state, and ZIP code
- **G** General partner or LLC member manager
- **H** Domestic partner
- **I** Foreign partner

#### Part II Information About the Partner (cont.)
- **J** Partner's share of profit, loss, and capital (see instructions):
  - **Beginning Profit**
  - **Beginning Loss**
  - **Beginning Capital**
  - **Ending Profit**
  - **Ending Loss**
  - **Ending Capital**

#### Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items
- **1** Ordinary business income (loss)
- **2** Net rental real estate income (loss)
- **3** Other net rental income (loss)
- **4** Guaranteed payments
- **5** Interest income
- **6a** Ordinary dividends
- **6b** Qualified dividends
- **7** Royalties
- **8** Net short-term capital gain (loss)
- **9a** Net long-term capital gain (loss)
- **10** Foreign transactions
- **11** Other income (loss)
- **12** Section 1250 deduction
- **13** Other deductions
- **14** Self-employment earnings (loss)
- **15** Credits
- **16** Alternative minimum tax (AMT) items
- **17** Unrecaptured section 1250 gain
- **18** Tax-exempt interest and non-deductible expenses
- **19** Distributions
- **20** Other information

---

*See attached statement for additional information.*

---

For Paperwork Reduction Act Notice, see Instructions for Form 1065.
“C” Corporation

• “C” Corporation is a business entity created under state law. Legally, it is considered an artificial person created to conduct business. Thus, it can hire employees, enter into contracts, and incur liabilities.

• Limited liability

• Equity capital

• Filing of Form 1120

• Business entity itself pays income taxes
**U.S. Corporation Income Tax Return**

**Form 1120**

**For calendar year 2012 or tax year beginning** __________, 2012, ending __________, 2012

Information about Form 1120 and its separate instructions is at www.irs.gov/form1120.

**A. Check if (4) Consolidated return (attach Form 810).
B. Lithograph control number.
C. Personal holding company (attach Sch. PH).
D. Partnership or S corporation (see instructions).
E. Schedule M-3 attached.**

**B. Employer identification number**

**C. Name**

**D. Date incorporated**

**E. Total assets (see instructions)**

<table>
<thead>
<tr>
<th>Income</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1a Gross receipts or sales</td>
<td>1b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1c Balance. Subtract line 1b from line 1a.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Cost of goods sold (attach Form 1125-A)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Gross profit. Subtract line 2 from line 1c</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Dividends (Schedule C, line 19)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Interest</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Gross rents</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Gross royalties</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Capital gain net income (attach Schedule D (Form 1120))</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Other income (see instructions—attach statement)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Total income. Add lines 3 through 10</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Deductions (See instructions for limitations on deductions.)**

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>12 Compensation of officers (see instructions—attach Form 1120-E)</td>
<td>13</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14 Repairs and maintenance</td>
<td>15</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16 Rents</td>
<td>17</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18 Taxes and licenses</td>
<td>19</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 Interest</td>
<td>21</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 Charitable contributions</td>
<td>22</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22 Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)</td>
<td>23</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23 Depletion</td>
<td>24</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 Advertising</td>
<td>25</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25 Pension, profit-sharing, etc., plans</td>
<td>26</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26 Employee benefit programs</td>
<td>27</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27 Domestic production activities deduction (attach Form 8903)</td>
<td>28</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>28 Other deductions (attach statement)</td>
<td>29a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>29b Add lines 28a and 28b</td>
<td>30</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**29a Net operating loss deduction (see instructions) | 30**

**29b Special deductions (Schedule C, line 20) | 31**

**30 Taxable income. Subtract line 29c from line 28 (see instructions) | 31**

**31 Total tax (Schedule J, Part I, line 11) | 32**

**32 Total payments and refundable credits (Schedule J, Part II, line 21) | 33**

**33 Estimated tax penalty (see instructions). Check if Form 2220 is attached | 34**

**34 Amount owed. If line 32 is smaller than the total of lines 31 and 33, enter amount owed | 35**

**35 Overpayment. If line 32 is larger than the total of lines 31 and 33, enter amount overpaid | 36**

**36 Enter amount from line 35 you want. Credited to 2013 estimated tax | 37**

**Signature of officer**

**Firm’s name**

**Preparer’s name**

**Date**

**Preparer’s signature**

**Date**

**Check if self-employed**

**Firm’s EIN**

**Firm’s address**

**Preparer’s phone number**

**For Paperwork Reduction Act Notice, see separate instructions.**

Cat. No. 114992

**Form 1120 (2012)**

---

**Tax Return Example**

**Form 1120**
“S” Corporation

• “S” Corporation is a corporation that has elected to be treated like a partnership for federal income tax purposes

• Pass-through

• Filing of Forms 1120S and 1040
  – Income of the corporation is captured on Schedule K
  – Taxes are paid by individual. However the S Corporation will likely have distributions to owners to pay income taxes
### Tax Return Example – Form 1120S

#### U.S. Income Tax Return for an S Corporation

**Form 1120S**

- Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.

For calendar year 2012 or tax year beginning 2012 ending ____________

**A.** S election effective date ____________

**B.** Business activity code number (see instructions)

**C.** Check if Sch. M-3 attached

**G.** Is the corporation electing to be an S corporation beginning with this tax year? __Yes__ __No__

**H.** Check (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation

**I.** Enter the number of shareholders who were shareholders during any part of the tax year ____________

#### Income

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a</td>
<td>Gross receipts or sales</td>
<td>1a</td>
</tr>
<tr>
<td>1b</td>
<td>Returns and allowances</td>
<td>1b</td>
</tr>
<tr>
<td>1c</td>
<td>Balance. Subtract line 1b from line 1a</td>
<td>1c</td>
</tr>
<tr>
<td>2</td>
<td>Cost of goods sold (attach Form 1125-A)</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>Gross profit. Subtract line 2 from line 1c</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Net gain (loss) from Form 4797, line 17 (attach Form 4797)</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td>Other income (loss) (see instructions—attach statement)</td>
<td>5</td>
</tr>
<tr>
<td>6</td>
<td>Total income (loss). Add lines 3 through 5</td>
<td>6</td>
</tr>
</tbody>
</table>

#### Deductions (see instructions for limitations)

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Compensation of officers</td>
<td>7</td>
</tr>
<tr>
<td>8</td>
<td>Salaries and wages (less employment credits)</td>
<td>8</td>
</tr>
<tr>
<td>9</td>
<td>Repairs and maintenance</td>
<td>9</td>
</tr>
<tr>
<td>10</td>
<td>Bad debts</td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Rents</td>
<td>11</td>
</tr>
<tr>
<td>12</td>
<td>Taxes and licenses</td>
<td>12</td>
</tr>
<tr>
<td>13</td>
<td>Interest</td>
<td>13</td>
</tr>
<tr>
<td>14</td>
<td>Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)</td>
<td>14</td>
</tr>
<tr>
<td>15</td>
<td>Depletion (Do not deduct oil and gas depletion)</td>
<td>15</td>
</tr>
<tr>
<td>16</td>
<td>Advertising</td>
<td>16</td>
</tr>
<tr>
<td>17</td>
<td>Pension, profit-sharing, etc., plans</td>
<td>17</td>
</tr>
<tr>
<td>18</td>
<td>Employee benefit programs</td>
<td>18</td>
</tr>
<tr>
<td>19</td>
<td>Other deductions (attach statement)</td>
<td>19</td>
</tr>
<tr>
<td>20</td>
<td>Total deductions. Add lines 7 through 19</td>
<td>20</td>
</tr>
</tbody>
</table>

#### Tax and Payments

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>22a</td>
<td>Excess net passive income or LIFO recapture tax (see instructions)</td>
<td>22a</td>
</tr>
<tr>
<td>22b</td>
<td>Tax from Schedule D (Form 1120S)</td>
<td>22b</td>
</tr>
<tr>
<td>22c</td>
<td>Add lines 22a and 22b (see instructions for additional taxes)</td>
<td>22c</td>
</tr>
<tr>
<td>23a</td>
<td>2012 estimated tax payments and 2011 overpayment credited to 2012</td>
<td>23a</td>
</tr>
<tr>
<td>23b</td>
<td>Tax deposited with Form 7004</td>
<td>23b</td>
</tr>
<tr>
<td>23c</td>
<td>Credit for federal tax paid on fuels (attach Form 4136)</td>
<td>23c</td>
</tr>
<tr>
<td>23d</td>
<td>Add lines 23a through 23c</td>
<td>23d</td>
</tr>
<tr>
<td>24</td>
<td>Estimated tax penalty (see instructions). Check if Form 2220 is attached</td>
<td>24</td>
</tr>
<tr>
<td>25</td>
<td>Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed</td>
<td>25</td>
</tr>
<tr>
<td>26</td>
<td>Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid</td>
<td>26</td>
</tr>
<tr>
<td>27</td>
<td>Enter amount from line 26 Credited to 2013 estimated tax</td>
<td>Refunded</td>
</tr>
</tbody>
</table>

#### Sign Here

- Signature of officer
- Date
- Title

#### Paid Preparer Use Only

- Print type preparer’s name
- Preparer’s signature
- Date
- Check [ ] if self-employed
- SSTIN
- Firm’s name
- Firm’s EIN
- Firm’s address
- Phone no.

For Paperwork Reduction Act Notice, see separate instructions.
Limited Liability Company (LLC)

• Limited liability company (“LLC”) is an entity owned by members that combine many of the tax advantages of a partnership with the liability protection of a corporation
Limited Liability Company (LLC)

- An eligible entity can elect its own classification for federal income tax purposes (i.e., “check the box” rules)
  - An eligible entity with at least two members can elect to be classified as either an association taxable as a corporation or partnership
  - An eligible entity with a single owner can elect to be classified as an association or to be disregarded as a separate entity from its owner

- An LLC considered to be a disregarded entity for federal income tax purposes would be treated similarly to a sole proprietorship and would file a Schedule C or E depending on the nature of the business
Tax Return Considerations

• Cash versus accrual basis
  – Accrual basis often is a better indicator of financial performance
  – If on cash basis, consider the following:
    • Accounts receivable, accounts payable, and inventory implications (revenue, cost of goods, and expense).
    • Equity implications
    • Working capital implications
  – If on cash basis, option to require financial information on an accrual basis
Internal Financial Statements Considerations

- Consider benefits to the limitations to using internal financial information
- Key is to scrutinize!
- Cash versus accrual basis
- Revenue recognition
- Understanding of who prepares
- Helpful in monitoring interim cash flows
- Comparison to budget / projections
Personal Financial Statement Considerations

– Key is to scrutinize!
– Compare to previous personal financial statements
– Obtain bank statements and supporting documentation for amounts
– Consider liquidity of assets
– Completeness of form
– Consider value and stability of assets
  • Nonmarketable securities and ownership interests – hard to value and often overstated
– CPAs can compile personal financial statements (including footnote disclosures)
Credit Report Considerations

• Predictor of future repayment capabilities
• Determine how borrower has managed personal obligations
• Important to analyze trends
• Always run a credit report on guarantors and borrowers especially when financial information is delayed
Projections Considerations

• Detailed discussion with management on how projections were determined
  – Conservative versus aggressive
  – Capital addition requirements
  – Working capital requirements
  – Financing requirements
  – Comparison to industry
  – Feasibility of plans

• Key is to scrutinize!

• CPAs can compile projections
Considerations in Analyzing Cash Flows

- Additional considerations
  - Debt service coverage ratio should at least be 1.2 (depending on industry)
  - Verification that all debt (projected debt) is included in calculation
  - Consider contingent liabilities
  - Consider delinquent taxes
  - Consider possibility of other liens
  - Compare to industry trends
  - Living expense percentages
  - Historic and future trends
  - Normalization
Considerations in Analyzing Cash Flows

- Additional ratios to consider when analyzing cash flows
  - **Quick ratio**
    - \[ \text{Quick ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Accounts Receivable}}{\text{Current Liabilities}} \]
    - Helps to determine whether or not the company has sufficient cash to cover its current liabilities
    - The higher the ratio, the greater the company's liquidity (i.e., the better able to meet current obligations using liquid assets)
    - Recommend ratio to be greater than 1.0 (depends on industry)
    - Compare to previous years and future projections
Considerations in Analyzing Cash Flows

- Additional ratios to consider when analyzing cash flows
  - Current ratio
    - $\frac{\text{Current Assets}}{\text{Current Liabilities}}$
    - Includes inventory and prepaid expenses (less than one year) in current assets (quick ratio does not)
    - Measures whether or not a firm has enough resources to pay its debts over the next 12 months
    - Greater than 1.2 (depends on industry)
    - Compare to previous years and future projections
Considerations in Analyzing Cash Flows

- Additional ratios to consider when analyzing cash flows
  - Debt ratio
    - Total Debt
      - Total Assets
    - Percentage of a company's assets that are provided by debt
    - High debt to assets ratio may indicate low borrowing capacity of a company, which in turn will lower the company’s financial flexibility
    - If ratio is less than 0.5, most of the company's assets are financed through equity. If the ratio is greater than 0.5, most of the company's assets are financed through debt
  - Compare to previous years and future projections
Considerations in Analyzing Cash Flows

- Additional ratios to consider when analyzing cash flows
  - Accounts receivable turnover ratios
    - **Receivables turnover ratio** = net receivable sales / average net receivables
    - **Average collection period** = 365 / receivables turnover ratio
  - Calculates the number of times receivables are collected during a period
  - Compare to previous years and projections along with industry trends
Considerations in Analyzing Cash Flows

- Additional ratios to consider when analyzing cash flows
  - Inventory turnover ratios
    - **Inventory turnover ratio** = cost of goods sold / inventory
    - **Average days to sell inventory** = 365 / inventory turnover ratio
  - A low turnover rate may point to overstocking, obsolescence, or deficiencies in the product line or marketing effort. However, in some instances a low rate may be appropriate, such as where higher inventory levels occur in anticipation of rapidly rising prices or expected market shortages.
  - Compare to previous years and projections along with industry trends
Considerations in Analyzing Cash Flows

• Additional ratios to consider when analyzing cash flows
  – Accounts payable turnover ratios
    • Accounts payable turnover ratio = purchases / accounts payable
    • Average days to sell inventory = 365 / accounts payable turnover ratio
  – A high ratio means there is a relatively short time between purchase of goods and services and payment for them. Conversely, a lower accounts payable turnover ratio usually signifies that a company is slow in paying its suppliers
  – Compare to previous years and projections along with industry trends
Considerations in Analyzing Cash Flows

- **Capacity**
  - “Shocks” – downturns in economy or interest rate fluctuations, will the company be able to service debt?

- **Liquidity**
  - Analyzing and reviewing liquid assets
  - Verification of liquid assets
  - Review and monitoring of deposit account activity
Hot Topics and Common Pitfalls

• Relying too heavily on debt service coverage ratio in the bank’s determination of the borrower’s ability to service debt
  – Consider balance sheet items such as accounts receivable, accounts payable, inventory, and accrued expenses
  – Consider commitments and contingencies
  – Consider borrower’s capital expenditures and impact on cash flow
  – Consider cash flow from operations, investing, and financing activities
  – Documentation of above considerations
Hot Topics and Common Pitfalls

• Normalization and future cash flows
  – Consider and identify unusual events and expected changes along with factoring into ratios
  – Expected changes can include additions/disposal of product lines, additions/disposals of locations, etc.
  – Consider non reported income and expenses
• Documentation of above considerations
Hot Topics and Common Pitfalls

- Consider whether or not the financial information used in the cash flow analysis was determined on the cash or accrual basis of accounting
  - If on cash basis, consider the following:
    - Accounts payable implications (impacts expenses)
    - Accounts receivable implications (impacts revenues)
    - Inventory implications (impacts cost of goods sold)
    - Other considerations
  - Caution use of balance sheet information
  - Ratios
Hot Topics and Common Pitfalls

- Obtain an understanding of client’s business
  - History of business
  - Understanding of key products and lines of business
  - Understanding competitive landscape of business
  - Succession plans
  - Significant changes or activity during the year
  - Future plans
  - Knowing background of key members of management
  - Documentation of above consideration.
Hot Topics and Common Pitfalls

• Consideration of borrower’s ability to manage cash
  – New borrowers to the bank
    • Credit reports
    • Review of deposit account activity
    • Accounts payable turnover ratio (compare to industry trends)
  – Current borrowers to the bank
    • Credit reports
    • Review of deposit account activity
    • Accounts payable turnover ratio (compare to industry trends)
    • Overdrafts
    • Past due information

– Documentation of above consideration
Hot Topics and Common Pitfalls

• Identify and predict the demands on cash that might compromise the ability to repay debt
  – Operations are funded by financing activities
  – Declines in credit report scores and increases in personal and business debt obligations
  – Significant declines in liquidity and cash flow ratios or ratios not in line with industry trends
  – Understand the borrower’s commitments and contingencies
  – Rapid growth – demand on working capital and investment in capital expenditures

• Documentation of above consideration
Hot Topics and Common Pitfalls

• Consideration of the seasonality of cash flows
  – Determine the effects of seasonality of business operations on the cash cycle
  – Payment and terms structure
  – Financial projections and budgets

• Documentation of above considerations
Hot Topics and Common Pitfalls

• Consideration of capital expenditures
  – In typical business debt service coverage ratio calculations, depreciation expense is typically added back to net income
  – However, if the borrower typically invests in capital expenditures, this may overstate cash flow and debt service coverage ratios

• Documentation of above consideration
Hot Topics and Common Pitfalls

- Consideration of quality of cash flows and liquidity
  - Quality of cash flows
    - Stretching out of payables
    - Timing of collections of receivables
    - Does cash flow increase as revenues increase?
  - Liquidity
    - Accounts receivable
    - Accounts payable – significant vendor terms
    - Working capital requirements and ability to meet short-term requirements
    - Marketable securities
- Documentation of above considerations
Hot Topics and Common Pitfalls

- Miscellaneous considerations
  - When calculating personal cash flow, do not ignore living expenses
  - Always obtain credit reports on borrowers and guarantors on an annual basis (even when other financial information is not available)
  - Consider obtaining a signed document from the borrower and guarantor that the bank can directly contact their CPAs for financial statements and tax returns
  - Comparison of ratios to industry
Hot Topics and Common Pitfalls

• Miscellaneous considerations (continued)
  – Ensure that credit analysts and loan officers are aware of key factors that may impact the cash flow analysis
    • Results of current year operations
    • Future plans
    • Unusual income and expenses and capital expenditures
  – Ensure that the appropriate risk weight for debt service coverage is included in the bank’s risk rating matrix
Final Thoughts and Key Takeaways

• Scrutinize and question information received from borrower.

• Consider future plans in cash flow analysis along with historical trends. Compare to industry trends.

• Understanding of whether or not cash flow is generated from operations, financing, or investing activities.

• Cash basis versus accrual basis of accounting and implications on cash flow ratios and analysis.

• Documentation of key considerations.
QUESTIONS?