

Common Mistakes in Global Cash Flow Analysis

By Brad Schaefer, Analyst, Sageworks, Inc.

As Global Cash Flow has become more of a necessity than an option, the majority of financial institutions are now performing some type of combined ratio analysis. The issue lies in the fact that there are several methods of Global Cash Flow (GCF) analysis being used; some leading to erroneous conclusions. Once regulators and the economic environment made GCF analysis imperative, banks started implementing some form of GCF calculation to satisfy credit risk management pressures, even if it was not the most accurate method available. It is vital for financial institutions to review their GCF analysis to ensure they are lending safely and productively. Below we will review what Global Cash Flow actually requires and look at some common mistakes made when performing a GCF analysis.

What is Global Cash Flow?

Global Cash Flow analysis is used to assess the combined cash flow of a group of people and/or entities to get a global picture of their ability to service the proposed debt. Global Cash Flow is looking at the business's cash flow, the owner's cash flow, and the cash flow of all related people and businesses and combining them in the proper way to arrive at global cash flow ratios such as Debt Service Coverage Ratio that will be the basis of a credit decision. It is no longer enough to simply look at the business by itself and the guarantors by themselves because owners and their businesses are becoming more and more comingled every year. Vimal Patel, Senior Director of Sageworks Financial Services Group, explains how business and personal cash flow can become comingled:

- It is common for owners to lend personal funds to or borrow funds from their businesses.
- It is common for the business (for tax advantages primarily) to rent its office/warehouse/production facilities from a real estate holding company or partnership controlled by the business owners.
- It is common for owners to control their own levels of salaries, bonuses, benefits and dividends to the extent allowed by prudence and tax regulations.

For more examples, read "[Global Cash Flow Analysis: Understanding Interrelated Businesses.](#)"

Common Mistakes in GCF Calculations

When performing a GCF analysis, there are several mistakes that financial institutions make that could be the difference between approving and denying a loan request:

1. Obtaining business and personal financials, but not combining them into a single cash flow

It may seem obvious that the above isn't even a GCF analysis by definition, but this mistake happens. The lender believes they are performing a 'Global' analysis by obtaining and analyzing all of the people and businesses involved in the loan request, but it is not truly Global until all of these cash flows are combined into a single GCF. Linda Heath, President of Financial Holographix ¹, emphasizes the importance of thinking "*net*" cash flow. "Owners and guarantors may be sources of business capital, but in down economies they become users of business cash flow, depending on their personal and other business obligations. Analysts must dig for potential indirect demands on resources that could prevent the borrower from repaying as agreed," says Heath.

2. Not analyzing (or requesting) all of the necessary tax forms

Tax returns and their supporting schedules are vital to performing a GCF analysis correctly. Without the necessary tax schedules, cash flow numbers can be greatly skewed due to using paper transactions that change 'income/expenses' for tax purposes but have nothing to do with actual

cash flow. For example, the K-1 forms are crucial for obtaining the distributions and contributions applicable to the individual, which provide an actual cash flow amount. As the OCC's Internal Guidance from April 9, 2008, explains:

An analysis of the guarantor's global cash flow should consider inflows, as well as both required and discretionary cash outflows from all activities. This may involve integrating multiple partnership and corporate tax returns, business financial statements, K-1 forms, and individual tax filings. Anything short of a comprehensive global cash flow analysis diminishes confidence in the assessment of guarantor strength, even in the face of significant liquid assets since that liquidity may be needed to fund contingent liabilities and global cash shortfalls.

3. Double-counting income

Again, it may seem obvious to remove portions of income that are counted twice (once by the business and once by the individual, for example), but this is a point that is often overlooked by less experienced analysts when performing their GCF analysis. The most common error starts when the business borrower is given full credit for EBITDA without subtracting distributions to shareholders. It is compounded when shareholder/guarantors are given full credit for 1040 Schedule E part II "earnings" rather than distributions. The error increases if shareholder K-1 earnings are added to their 1040 E part II amounts. "When cash flow is accurately reflected between the business and shareholders, bankers will be able to evaluate whether they can rely on the primary source of repayment, or must lean on a secondary source of repayment and have a defensible GCF," says Heath.

4. Inconsistencies between employees in GCF analysis

This key point is often unnoticed by financial institutions. Each employee performing GCF needs to execute it in the same way to create consistency at the bank. Different people calculating GCF in different ways will result in poor loan, pricing, and risk rating decisions. A consistent approach to Global Cash Flow should be a top priority for banks once they decide on a standard and accurate GCF method. Heath has observed firsthand how regulators pick up on these inconsistencies and exploit them during reviews: "Regulators are taking a hyper-cautious approach to risk rating your loans. Once they find inconsistencies in your calculations they dig deeper. Every \$1 million loan that is downgraded can cost your bank tens of thousands in ALLL reserves."

Summary

Global cash flow has quickly become a litmus test for credit analysis and risk rating. However, analysts and lenders must apply industry best practices to their GCF process to ensure accuracy. In addition, Chief Credit Officers and members of your loan committee must insist on quality and consistency across individuals and departments. Used properly, GCF can easily become the most valuable and accurate credit risk management tool available when making lending decisions. Performing a precise Global Cash Flow analysis is not only helpful to the bank, but also to the health of the economy and to the individuals trusting the bank to provide insight and judgment on the validity and security of their loan requests.

¹Linda Heath is President of Financial Holographix, a firm that provides credit analysts to community banks and a certified Sageworks Analyst trainer. She has 20+ years commercial lending and underwriting. You can reach her at LHeath@Financial-Holographix.com with any questions.

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