THE DEFINITIVE GUIDE TO GLOBAL CASH FLOW

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In today’s financial services industry, there is little room for poorly informed loan decisions. Especially given the recent change in BASEL requirements, a true understanding of risk is essential if your financial institution is to comply with regulatory guidelines. Unfortunately, global cash flow analysis, a key component that regulators evaluate, can be a difficult and sometimes error-prone process. Therefore, financial analysts at Sageworks put together this guide on global cash flow analysis to address some of the common questions and challenges.
WHY SHOULD I CONDUCT **GLOBAL CASH FLOW ANALYSIS**?

**IN SUMMARY, THE FOLLOWING MAY HAPPEN IF YOU DON’T LOOK AT GLOBAL CASH FLOW:**

- **Income or debt could be easily overstated**
- **Loan decisions could be made with inaccurate debt and cash flow information**
- **Increased risk if the guarantor’s already stretched to the limit**

**Although business and personal expenses are considered separate outlays for a business and its owners, they are often mixed together. As such, conducting a cash flow analysis that treats personal cash flow as separate from business cash flow may result in the following problems:**

- An overlap between the business owners’ personal and business cash flow: Business owners frequently borrow from their business’s cash stores as well as deposit their personal cash as investment in their business. Therefore, without [global cash flow analysis](#) it is likely that these cash flows will be double-counted.

- Due to the tax advantage of doing so, businesses will often rent their office/warehouse/production facilities from a real estate holding company or partnership controlled by the business owners. With traditional analysis, it’s hard to tell what amount of cash flow is really attributable to the individual business owners.

- Business owners often control their own salaries, bonuses, benefits and dividends from the business to the extent allowed by prudence and tax regulations. In this case, traditional cash flow analysis may double-count these items by combining both personal and business cash flows.
WHEN TO CONDUCT **GLOBAL CASH FLOW ANALYSIS**?

At what point in the credit analysis processes should this analysis be performed?

1. **Loan Underwriting**

   It’s no surprise that a new loan application -- whether it is from a current bank customer or an entirely new borrower -- should require a financial spread, including a review of global cash flow. Business relationships may have changed since the customer last interacted with the bank, introducing new guarantors and potentially new obligations. And for new borrowers, those additional obligations (either from another business relationship or balances at another financial institution) might otherwise not be considered.

   During the bank’s safety and soundness exam, examiners will expect to see a consistently applied global methodology as part of origination.

2. **Loan Review**

   If a loan has a complex borrower relationship, a global cash flow analysis should be part of the annual review. Especially if the loan has shown signs of deteriorating credit quality, the comprehensive analysis provided by a global cash flow spread would be necessary to appropriately rate risk.
HOW TO CONDUCT GLOBAL CASH FLOW ANALYSIS?

There are two methods of conducting global cash flow analysis, a standard and a modified form. Standard cash flow analysis is usually sufficient. But, if there are three or more guarantors, the modified global cash flow method should be used.

**Standard form:** For small businesses

- Where guarantor cash flow weighs heavily on the global relationship performance.
- Where there are fewer than three owners who have 70-100 percent of aggregate ownership.
- Where business cash flow is the primary source of cash flow in the relationship.
- Where you think business and personal income are commingled.

**Modified form:** There are three or more guarantors

- Where there are many guarantors that could potentially impact the global entity’s cash flow (i.e., law firm with 25 partners).

How to conduct global cash flow analysis, in-brief:

**Standard form:**

- Use tax forms and financial statements to calculate personal cash flow and contributions from pass-through entities.

**Modified form:**

- Start with the standard form but use net personal cash flow after debt service for each individual and add it to the total business cash flow.
- Set a target debt service coverage ratio of 1.5x.
- Both business cash flow and global cash flow should be analyzed to compare the cash flows in each scenario.

A NOTE:

In complex lending situations, such as those with a very large number of guarantors, it’s preferable to use a full UCA Statement of Cash Flow analysis, which details the sources and uses of cash flow from changes in the Balance Sheet, rather than the gross and net methods.
GLOBAL CASH FLOW

When conducting a standard global cash flow analysis, it’s important to follow these best practices:

- When you are assessing the cash flows, it’s important to combine the business and personal cash flow but make certain that you are not double-counting cash flow that comes from the commingling of the two entities.

- Be sure to look for commingled business and personal debt, as well.

- For loans that are classified as “interest only,” the debt service should be calculated using imputed amortization.

- For lines of credit, assume that they are fully drawn by the business or owner.

- Assume that more than the minimum payment is being made on credit cards.

- Deduct a living expense percentage of the individual’s salary (15-20 percent is a common guideline).

- Use K-1s instead of investment income reported on the 1040 E Part II for an accurate assessment of personal cash flow.
KEY DECISIONS IN **GLOBAL CASH FLOW**

Now that we’ve established the basic method to conducting global cash flow analysis and important best practices, it’s time to talk about some key decisions you must make when conducting the analysis.

*Note: With the following decisions, it is important that your financial institution applies whatever method it chooses consistently to avoid regulatory scrutiny.*

**Determining cash flows where the individual(s) do(es) not own 100 percent of the business:**

**Option 1:** Some lenders use K-1 Distributions/Contributions only, regardless of the percent of ownership.

Although this option can be applied consistently, the analysis may falter as it will not be truly global if it does not include the debt service from the business entity in instances where the individual is a clear majority owner.

**Option 2:** Some lenders will base their decision on percent of ownership.

For a pass-through entity where the individual has clear majority ownership (70 percent or more), include full business cash flow and debt service.

For a pass-through entity where the individual has clear minority ownership (less than 30 percent), include K-1 distributions/contribution and exclude most to all of the debt service.

For situations in between, use your best judgment, remembering to set a [consistent analysis policy](#) for these situations across your institution.
KEY DECISIONS IN GLOBAL CASH FLOW (CONTINUED)

Choosing which type of Debt Service Coverage Ratio to use: Average or most recent?

In general:
- If there is no clear DSCR trend, use average DSCR.
- If DSCR is improving, use average DSCR to account for cyclicality.
- If DSCR is deteriorating, use the most recent DSCR.

But in the current financial environment:
- Some lenders will apply a weighted average system that puts an emphasis on more recent years as it may be more reflective of “normal” conditions.
KEY DECISIONS IN GLOBAL CASH FLOW (CONTINUED)

Recurring versus Nonrecurring Items: Dealing with Capital Gains

The business may sell marketable securities of the company.

For example, in the case of a stock sale:
- Cash flow is the proceeds, not the gain or loss.
- You need to decide whether this stock sale is going to be considered a recurring source of cash.
- If it is recurring, do they have similar assets to make future sales? If so, those sales will impact cash flow.

Look at Form 4797/ Form 6252 to account for capital gains from non-stock items.

**Form 4797: Sale of Business Properties**
- Ask questions such as: Is this sale recurring? Do they have other properties? How are they using the proceeds?
- If it’s not a recurring sale, how can you adjust their taxes to get a true reflection of cash flow?

**Form 6252: Installment Sale Income**
- Usually this is considered a recurring item and should be included in the cash flow.

**Net Operating Loss Carry-Forwards and Carry-Backs**
- Add back the Net Operating Loss carry-forward as a non-cash item (similar to how depreciation is added back).
- Reference amended tax returns for prior years if using Net Operating Loss carry-back.
COMMON PITFALLS

Now that we’ve gone through the keys to a well conducted global cash flow analysis, remember to watch out for the following common mistakes:

- Be sure to discern and remove overlapping cash flow in the global combined cash flow available; common areas where this is neglected include:
  - A business is given full credit for EBITDA without subtracting distributions to shareholders.
  - If shareholders/guarantors are given full credit for 1040 Schedule E Part II “earnings” rather than distributions or contributions. Using the K-1 distributions or contributions rather than the Schedule E Part II is recommended, if both schedules are available from guarantors.

- Don’t forget to request all the tax forms and financial statements you may potentially need from an individual. This will likely include:
  - Multi-partnership and corporate tax returns (1065, 1120S, or 1120)
  - Business financial statements (audited or complied)
  - Individual tax returns and statements (1040 and PFS)
  - K-1s

- Distributions can be misleading when taken in isolation. Sometimes owners pay themselves more or less depending on the economic environment or the business’s position.

- Situations with multiple borrowers or guarantors should be fully analyzed to take into account any low performing businesses for which the guarantors are responsible.

- Ensure that all analysts in the financial institution use the same methodology for calculating global cash flows. Calculating global cash flow differently will result in poor loan decisions, loan pricing, and risk rating decisions.
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Sageworks Credit Analysis is a robust commercial credit spreading and global cash flow analysis solution that helps bankers make more profitable lending decisions and objectively measure credit risk.

To find out more, visit www.sageworksanalyst.com.

“Policy Statement on Prudent CRE Loan Workouts,” Federal Reserve

“Understanding Interrelated Businesses,” Sageworks.
https://www.sageworksanalyst.com/articles/globalcashflow.aspx
