
FINANCIAL ANALYSIS ISN'T ENOUGH TO BANK ON

Financial analysis lays the foundation, but credit analysis builds the wall

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UNconventional Wisdom is a periodic guest blog, where authors hold up the so-called conventional wisdom to a fresh perspective, or apply common principles in new ways. To propose a guest blog, email Steve Cocheo, executive editor & digital content manager.

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By Jeff Judy. Jeff is principal of Jeff Judy & Associates, and has more than 30 years experience as a banker, trainer, and consultant. He's a nationally known trainer serving individual banks, bank holding companies, major banking schools, and trade associations at state and national levels, and also consults with bank leadership on policy, process, and culture.

Any conversation about commercial credit will include the word "analysis" quite a few times. The decision to extend credit to a business, even with all our sophisticated software, often remains a challenging judgment call, and the quality -- and the ultimate appropriateness, based on the final outcome--of that judgment is highly dependent on the quality of the analysis.

But all analyses are not created equal, I'm afraid.

It isn't just a question of the analytical tools or the skill of the analysts. It has to do with the fundamental thinking underlying the purpose and practice of analysis.

Two sides of the same coin

One way to look at it is to say there are two kinds of analyses in the business lending world, and two kinds of perspectives on what bankers are actually doing:

1. Some bankers and analysts do financial statement analysis as part of making a loan.
2. Other bankers and analysts do credit analysis as part of making a credit decision.

Don't get me wrong, I'm not knocking financial statement analysis. I think it is a valuable component of a credit analysis. I just don't think financial statement analysis goes far enough, largely because it doesn't ask any of the key questions.

But it does create the opportunity to ask more focused questions regarding the borrower's understanding of their business outcomes.

When I see the analysis process putting too much emphasis on "the numbers," I grow concerned. The numbers that financial statement analysis generates are a snapshot. They tell you where the borrower is now and in the past.

And those numbers do have meaning. Comparing ratios, for example, to what are considered acceptable thresholds at your bank certainly gives you some indication of the potential borrower's financial health.

But if all that those numbers coming out of financial statement analysis mean to you is, "It clears the threshold" or "It's too low," you're missing a lot.

After all, when is the last time you were repaid by a number?

What are you really looking for?

The truth is, today's loan is repaid with tomorrow's cash.

And that means that the only way you can make a loan with confidence that it will be repaid is if you make a judgment about the future financial health, and cash flow, of the borrower.

That's where we get into credit analysis. The process of making a credit decision starts with the recognition that those numbers shown on the most recent financial statements did not get there by themselves, nor were they plucked out of

thin air (hopefully!).

Those numbers are the consequences of a series of decisions and actions by your potential borrower. They reflect the business and economic environment of the preceding periods. But they also reflect the responses of the borrower to those conditions.

Your job, in credit analysis, is to make your best assessment of what the business environment will look like when repayment time rolls around, and also to make an informed prediction about how the borrower will respond to conditions between now and then.

That means asking more, and more interesting, questions about the financial information.

Comparing two approaches

A financial statement analyst asks, first, "What is the number (e.g., ratio)?" and then, "It is good enough?"

But a credit analyst also asks, "Why is that number what it is?"

Perhaps a low number is the result of economic turmoil, but perhaps it is more the result of management decisions.

With basic financial performance, you know where the borrower is today. You can extrapolate those numbers, assuming that not much changes in either external conditions or borrower management, and that gives you one possible future.

But when you are making a sound credit decision, when you are determining whether the borrower will be "creditworthy" tomorrow and not just whether they are "financially worthy" right now, you don't just extend a trend line. You adjust that line to reflect the changes you anticipate in your market and in the economy. Then you look at possible responses from the borrower that could boost or reduce your probability of full repayment.

For the financial statement analyst, the future is a simple extension of the present. But for the credit analyst, the future is individually crafted, with the current financial statement analysis as input.

Where financial statement analysis is fairly self-contained, credit analysis looks for information outside of the statements. Credit analysis requires information about economic, business, even legislative and regulatory changes that may be arriving in the near future. Credit analysis takes interviews with business owners and site visits into account when creating that vision of the future in which the borrower will repay.

Bankers need all of it

Numbers are important. They help us see things that we might not notice without them. They help us compare things that would be hard to put side by side, in a meaningful way, without the figures.

But there is more to "vision" than "seeing," and there is more to making a credit decision than "running the numbers."

Without a vision of the borrower's future, one based on a wide range of information that includes, but extends beyond, financial statement analysis, you're going to run into more ugly surprises than you would like.

It's time to get out of the "lending by the numbers" business and into the "credit decision" business.