

TO: State Directors, Rural Development

ATTN: Business Programs Directors

SUBJECT: Business and Industry Guaranteed Loan and  
Section 9007 Rural Energy for America Programs  
Lender Financial Analysis Requirements

PURPOSE/INTENDED OUTCOME:

This Administrative Notice (AN) is to provide guidance to lenders and State Office personnel on the minimum spread requirements and financial analysis standards that the lenders must perform to comply with RD Instruction 4287-B, section 4287.107(d), and Form RD 4279-4, "Lender's Agreement," paragraphs IV(c) (6) and (11). This AN delineates the minimum financial analysis that Business and Cooperative Programs believes a reasonably prudent lender would use for a performing loan. The Agency is also emphasizing the need and requirement for State Offices to maintain and track the servicing activity of nondelinquent problem loans in the Guaranteed Loan System (GLS). This guidance is also applicable to meeting the requirement contained in RD Instruction 4279-B, section 4279.161(b) (8).

The State Offices are requested to notify all lenders, in writing, that failure to obtain or analyze financial statements or properly service loans could be considered negligent servicing and the Loan Note Guarantee may be commensurately reduced as a result.

COMPARISON WITH PREVIOUS AN:

This AN replaces RD AN No. 4308 dated September 12, 2007, which expired on September 30, 2008.

EXPIRATION DATE:  
October 31, 2009

FILING INSTRUCTIONS:  
Preceding RD Instruction 4279-B,  
4280-B, and 4287-B

**IMPLEMENTATION RESPONSIBILITIES:**

The lender is responsible for obtaining and forwarding to the Agency the financial statements required by the Loan Agreement. The lender is responsible for providing the Agency with: (1) an analysis of the borrower's financial statements (including spreadsheets); and (2) a written trend analysis that compares the borrower's year-to-year historical financial information. The lender's analysis should also include a borrower ratio comparison to industry standards for similar size businesses. The lender's written analysis to the Agency must include the borrower's strengths, weaknesses, and extraordinary transactions. The analysis should identify any loan agreement violations and other indications of the financial condition of the borrower. The lender will submit the annual financial statements to the Agency, along with its spreadsheets and written analysis, within 120 days of the end of the borrower's fiscal year. Upon receipt, your office should spread and analyze the borrower's annual financial statements. A copy of the analysis will be filed in the case file.

It is the Agency's position that, at a minimum, a reasonably prudent lender would prepare the ratios identified on the attachment to this memorandum and provide this information to the Agency, along with its written summary of the analysis. Promptly obtaining and reviewing financial information from the borrower can reveal financial red flags that indicate problems the borrower may be experiencing and has not disclosed. These indicators provide guidance for adequately servicing the loan. A review of the financial statements assists the lender and State Office in determining the appropriate action that will maximize recovery to the Agency. It is important to note that every borrower is different. As such, we recognize economic conditions change, industry conditions are not constant, and public policy and community relations affect how lenders deal with problem loans.

A nonexclusive list of the lender's servicing responsibilities is contained in Form RD 4279-4, "Lender's Agreement," paragraph IV. The lender's servicing responsibilities include obtaining compliance with the loan covenants and getting the borrower's periodic financial statements, as required by the Loan Agreement.

We must increase our efforts to obtain financial statements, review lenders analyses, and provide follow-up to lenders on servicing deficiencies. Our files should be documented to show our attempts to obtain the required information.

For loan processing, it is the Agency's position that a reasonably prudent lender's financial analysis would consist of a complete, written analysis discussing: (1) adequacy of equity; (2) cashflow and repayment ability (including a cashflow analysis); (3) collateral; (4) borrower's management; (5) the borrower's history of credit and debt repayment; and (6) the necessity of any debt refinancing, (which should address the eligibility criteria outlined in RD Instruction 4279-B, section 4279.113(r)). The lender's analysis must also include spreadsheets of the balance sheets and income statements for 3 historical years and 2 projected years as well as a

pro forma balance sheet at loan closing that reflects the post-closing status. These spreadsheets should be common-sized and the figures compared to industry standards.

In addition, the State Office should place increased emphasis on maintaining the GLS in a current status on all Business and Industry (B&I) guaranteed loans, which includes reporting all nondelinquent problem loans into GLS. The B&I Guaranteed Loan Program is growing, and it is important that the Agency properly monitor guaranteed lenders to minimize potential losses to the Government. As part of the Business and Cooperative Programs Assessment Reviews, the National Office has implemented an observation and comparison of nondelinquent problem loans serviced by the State Office and the numbers reported in the GLS. Periodically, you may also be asked to submit your GLS reports of nondelinquent problem loans to the National Office for spot reviews.

In accordance with RD Instruction 4280-B, section 4280.152(a), all Section 9007 Rural Energy for America guaranteed loans are to be serviced in accordance with RD Instruction 4287-B, section 4287.107.

If you have any questions, please contact the B&I Division, Servicing Branch, at (202) 690-4103.

*(Signed by Ben Anderson)*

BEN ANDERSON  
Administrator  
Business and Cooperative Programs

Attachment

## FINANCIAL STATEMENT ANALYSIS

At a minimum, the lender's financial analysis should include, but is not limited to, the following:

1. **Current Ratio:** Measures the ability of a company to pay its currently maturing obligations on a timely basis. It shows the amount of protection provided by a company's current assets relative to its current liabilities.

$$\frac{\text{Total current assets}}{\text{Total current liabilities}}$$

2. **Quick Ratio:** Expresses the degree to which current liabilities of a company are covered by the most liquid current assets. This acid test ratio is a more stringent measure of liquidity than the current ratio, because the quick ratio includes only the most liquid current assets or those that can be quickly converted to cash at amounts close to their book value.

$$\frac{\text{Cash} + \text{Accounts receivable (trade)} + \text{Marketable securities}}{\text{Total current liabilities}}$$

3. **Days Accounts Receivable Ratio:** Expresses the average time in days that receivables are outstanding. The collection period varies greatly for different types of companies and it is important to make comparisons with similar companies or to look at trends over time.

$$\frac{365}{\text{Net sales/Accounts receivable}}$$

4. **Days Inventory Ratio:** Measures the company purchasing, selling, and manufacturing efficiency, but is meaningful only in relation to the company's past performance and the performance of similar companies in the same industry.

$$\frac{365}{\text{Cost of goods sold/Inventory}}$$

5. **Debt-to-Worth Ratio:** Provides an indication of how well the investment of the shareholder in the company protects a creditor debt. It also measures how much the shareholders have at risk versus how much the creditors have at risk and, thus, the strength of the company capital structure.

$$\frac{\text{Total liabilities}}{\text{Tangible net worth}}$$

6. **Times-Interest-Earned Ratio:** Measures what proportion of the company earnings is needed to pay interest on its debt. A ratio of 1 is almost mandatory, since a lower ratio would indicate company earnings are insufficient to cover the interest on its debt.

$$\frac{\text{Earnings before taxes} + \text{Interest expense}}{\text{Interest expense}}$$

7. **Debt Service Coverage Ratio:** Measures the proportion of a company's net profit and noncash expenses that will be needed to pay the principal portion of long-term debt in the coming year.

$$\frac{\text{Net profit} + \text{Depreciation} + \text{Other non-cash charges}}{\text{Current maturities of long-term debt}}$$

8. **Return-On-Sales Ratio (or Net Profit Margin):** Measures the extent to which revenues of a company exceeds all its expenses, that is, how much profit the company earns on each dollar of sales.

$$\frac{\text{Profits before taxes}}{\text{Net sales}}$$

9. **Return-on-Assets:** Measures the profitability of a company in terms of how efficiently it uses its assets.

$$\frac{\text{Profit before taxes}}{\text{Total assets}}$$

10. **Return-on-Equity Ratio:** A high return, normally associated with effective management, could indicate an under-capitalized firm. A low return, usually an indicator of inefficient management performance, could reflect a highly capitalized, conservatively operated business.

$$\frac{\text{Profit before taxes}}{\text{Tangible net worth}}$$