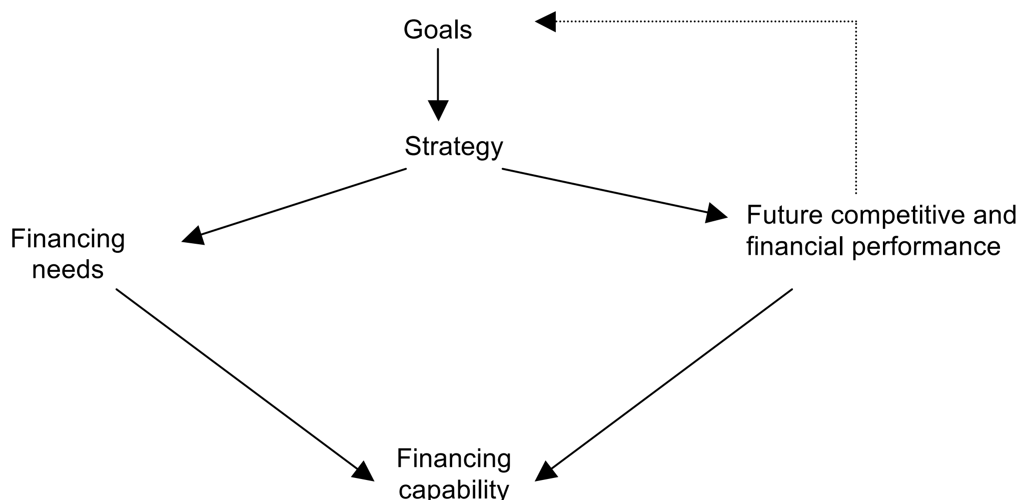
Is Your Company Financially Sound?

An assessment of the long-term financial wellbeing of a company is an important task for outsiders considering the extension of credit and for insiders in their formulation of strategy. History abounds with examples of companies that embarked upon overly ambitious programs and subsequently discovered that their portfolio of programs could not be financed on acceptable terms. The outcome frequently was the abandonment of programs in midstream at considerable financial and organizational cost to the company, its vendors, its employees, and/or its creditors.

A necessary first step in the evaluation of a company's financial soundness is the development of a comprehensive series of questions. It is possible to calculate a multitude of ratios, but unless they relate to specific questions and concerns, their usefulness will be minimal. Furthermore, unless one starts with a clear understanding of the right questions, one's analysis will inevitably be determined by whatever information is readily available.

The following represents some of the questions that seem important in assessing the future financial soundness of a company. The key issues are whether or not the company's goals, strategy, investment requirements, and financing capabilities are in balance.



1. Will the company need to raise additional finance over the next year/over the next three to five years to carry out strategically important programs? What are management's goals for the company? How does it plan to reach these goals? What investments must be made in working capital and in plant and equipment to support the programs? Will the company be a generator of excess cash, or will it be a consumer of cash?

   How important is its future access to finance from outsiders?

   a. Does the company have a seasonal financing need? If so, how large is it and what will be the perceptions of suppliers of finance at the time of the need?
   b. Might the company have a cyclical financing need? If so, how large might it be and what will be the perceptions of suppliers of finance at the time of the need?
   c. Does the company have a long-term need for additional finance? If so, how large is it and what will be the perceptions of suppliers of finance at the time of the need?

2. Is the company profitable? (Future profitability is one of the keys to raising finance)
   a. What are the underlying financial accounting practices? For example, are all subsidiaries consolidated? What lives have been assumed for depreciation purpose?
   b. What is the trend in profitability? Is the improvement due to:
      (1) Short-lived supply shortages?
      (2) Opportunistic changes in financial accounting?
      (3) Cyclical factors?
      (4) Curtailment of strategically important expenses?

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c. Is the return on equity high/low/average due to:

(1) Its operating margins?

(2) Its asset utilization?

(3) Its financing mix?

d. Is the level of profitability sustainable, given the outlook for the market and for competitive and regulatory pressures?

e. Are the earnings available to corporate or are they blocked in other countries?

3. Are there any “hidden” problems?

a. Suspiciously large levels and/ or build-ups of accounts receivable or inventories relative to sales, given the competitive and operating characteristics of the business? What is the historical trend in collection period, inventory stock turn? Do the absolute levels seem reasonable?

b. Unconsolidated subsidiaries with high debt levels?

c. Large contingent liabilities or unfounded pension liabilities or uncompleted contracts?

d. Lease commitments not shown on balance sheet?

4. How soundly is the company financed, given its riskiness and its future need for additional finance?

a. What is the maturity structure of the company’s debt? Is it faced with large debt repayments in the near future?

b. How current is the company in the payment of its suppliers?

c. What is the foreign exchange exposure of the company?

d. Is the company close to its borrowing limit in terms of restrictive covenants?

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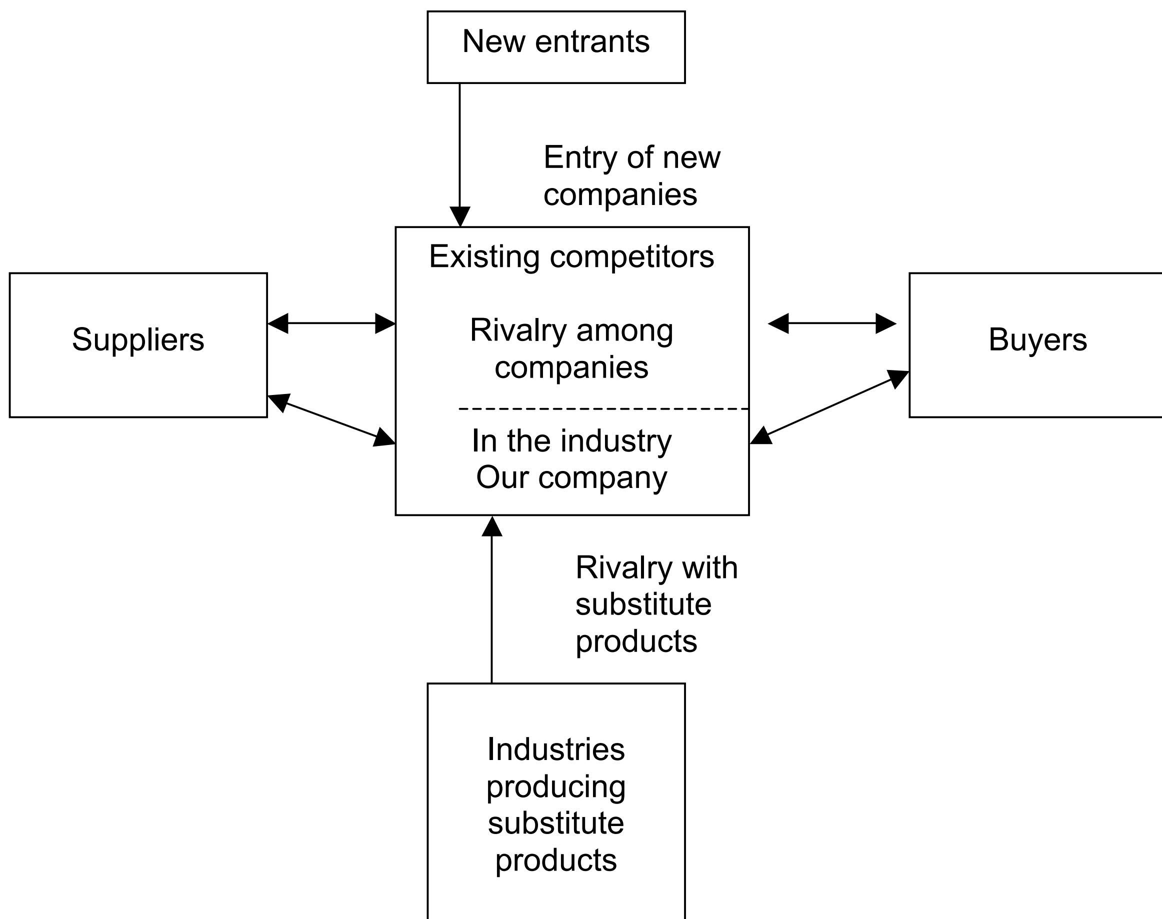
e. Is the company within its capacity to service the debt?

(1) Will it service the debt by paying the interest and principal out of internal cash flow?

(2) Will it service existing debt by selling new debt?

SOURCES OF DOWNWARD PRESSURE ON ABOVE-MARKET RETURNS



5. Does the company have assured access on acceptable terms to external sources of funds in amounts needed to meet its seasonal/cyclical/long-term needs?

a. Can the company raise equity funds?

(1) Is there a market for the shares?

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(2) How many shares could be sold?

(3) At what price could the shares be sold?

(4) To whom would new shares be sold?

(5) Would management be willing to sell equity?

(a) Concern about control?

(b) Concern about impact on canings per share and dividends per share?

b. Can the company raise long-term debt?

(1) Who are the possible suppliers?

(2) What are their criteria for lending?

(3) How well does the company meet these criteria?

(4) How much additional long-term debt can the company raise? On what conditions? At what price? How quickly?

c. Can the company raise short-term debt?

d. How well will the financing plan work if adversity strikes?

e. Does the company have assets that could be sold to raise funds? How quickly could they be sold?

6. Are the company's goals, product-market choices and strategies, investment requirements, financing needs, and financing capabilities in balance?

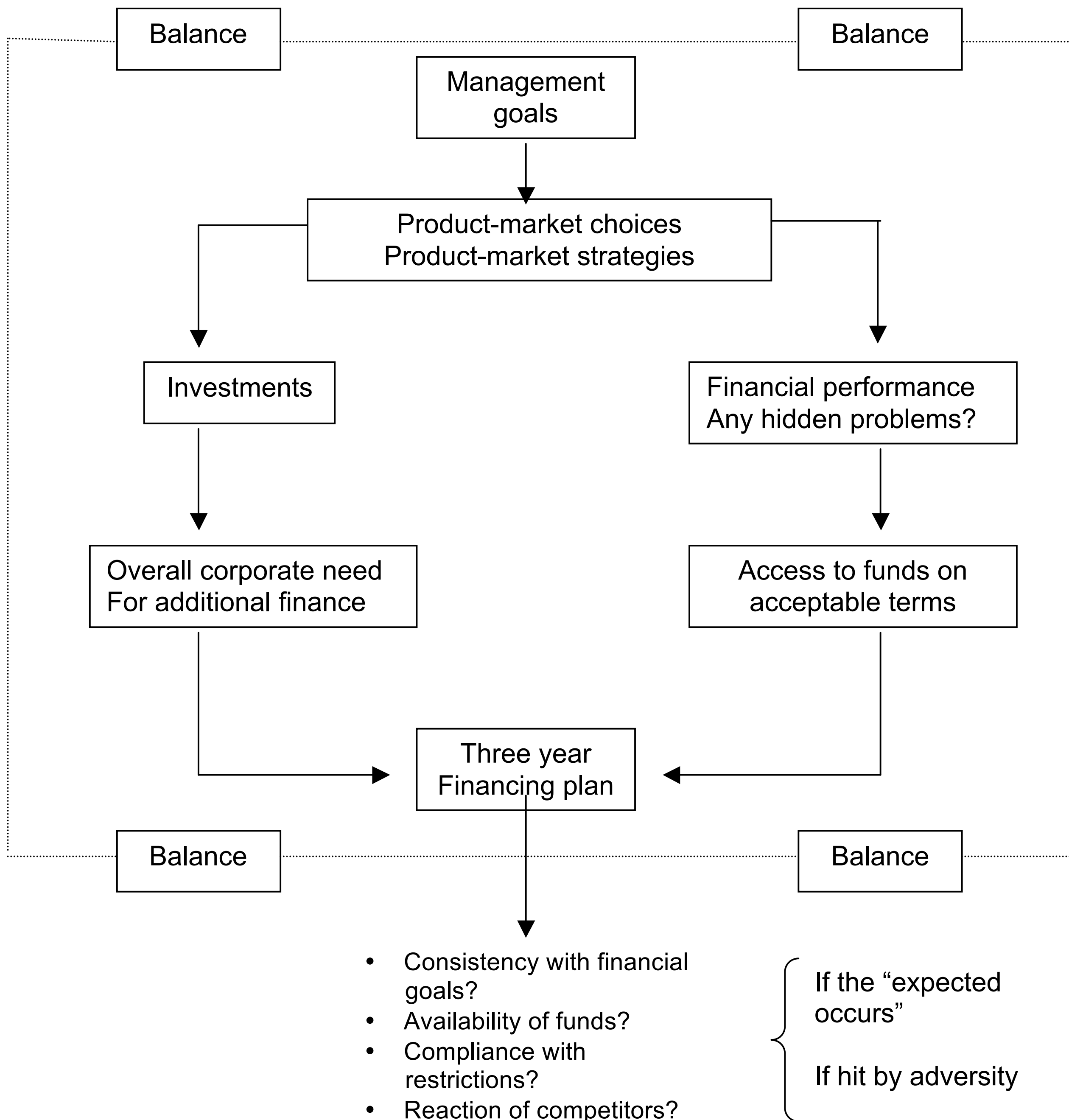
7. Will the company's goals, strategies, investment requirements, financing needs and financing capabilities remain in balance if the company is struck by adversity?

   a. What are the main regulatory, competitive, and operating risks? What combination of them might reasonably be expected to occur?

b. How would management respond in strategic and operating terms?

c. What would the implications be for future financing needs? For future financial performance?

d. Will it be possible to raise the finance needed on acceptable terms, given the perceptions of suppliers of finance and of the company's strategic, competitive, and financial performance?



- Consistency with financial goals?
- Availability of funds?
- Compliance with restrictions?
- Reaction of competitors?

If the "expected occurs"

If hit by adversity

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Clearly, many of the questions go beyond the information contained in the published financial statements of a company. Many require an understanding of (1) future industry economics and structure, (2) the competitive and operating characteristics of the business, (3) the long-term goals and plans of management, (4) the lending criteria of various segments of the capital markets, and (5) the soundness of management. Analysis of the published financial statements and the footnotes to the statements is only one part of a complete analysis of the future financial soundness of a company.

It is also clear that the evaluation of a company's "financial wellbeing" can vary substantially, depending on the perspective of the individual asking the questions. A bank or supplier considering the extension of seasonal credit may considerer a company a very safe bet; whereas a long-term lender dependent on the soundness and profitability of the company over a 15-year period may be very nervous.

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