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Guidelines for Spreading Financial Statements

Purpose:

This paper provides guidance on spreading the financial statements of foreign borrowers or guarantors using spreading software. While Eximbank uses Moody's KMV's Financial Analyst, this guidance can also be used for other spreading software. The analyst should review the item in the financial statement, then if in doubt, read the guidance on that item. This paper also lists which financial statements and reports Eximbank reviews when performing credit analysis.

General Items:

A. Combined or consolidated statements - Note on the spreads if the statements are combined or consolidated.

B. Indicate on each page the currency and if the figures are actual or are in thousands or millions.

C. Auditor's reports -Enter the auditor's name and type of opinion: unqualified, qualified, adverse or disclaimer of opinion. Compilations or reviews - If applicable, so note.

D. Exchange rates to be used - If statements for individual years are being spread, the year-end rate should be used for both historical cost and inflation-adjusted statements. In the latter case, this is because under comprehensive inflation accounting techniques, such as I.A.S. 29 and Bulletin B-10 in Mexico, the balance sheet and income statement figures are adjusted to end-of-the-year equivalents. When comparative statements are issued, standard practice is for the first year's figures to also be stated in end-of-the-second-year equivalents. Therefore, year two year-end exchange rate should also be used for the first year. With comparative statements distortions will not result if the inflation and devaluation rates (in terms of

local currency per U.S. dollar) are about the same. If the rates are different, for example Turkey from 1998 to 2002, only the most recent year in a set of comparative statements should be used. Exchange rates provided by the IMF should be used, or if those rates are not available to the user, OANDA (www.oanda.com) is the other recommended source.

E. Moody's KMV's Financial Analyst general purpose model is called Middle Market Analysis System ("MMAS"). For countries that use International Accounting Standards or that otherwise employ comprehensive inflation accounting techniques (Mexico/Bulletin B-10), the English High Inflation model ("EHI") should be used. The EHI model can convert statements for earlier years to end-of-the-most-recent-year equivalents. Only the EHI model will accept different exchange rates for the balance sheet (year-end) and income statement (yearly average).

F. Caution should be exercised in deciding in which line certain accounts should be entered in Financial Analyst or other software programs so that the accounts are properly treated as operating, investing or financing activities in the statement of cash flows. For instance, in Financial Analyst, the "accounts/notes receivable - related company(ies)" account will be picked up in the cash flow statement as an investing activity. The analyst should determine if this account is trade related, and if it is, create an account which will be treated as an operating activity. To determine which activity will be affected by an account, put the cursor on the account, right click, click on "spreading guide," and the activity will appear at the bottom.

G. Financial statements and reports - Eximbank reviews the balance sheet, income statement, statement of cash flows and the "Financial Ratios" report. We prefer reports where the local currency and U.S. dollar equivalent values are listed side-by-side. However, if the software does not generate side-by-side statements, we will review separate foreign currency and U.S. dollar statements. Side-by-side

statements can be printed in Moody's MMAS model by selecting the "Detailed Balance Sheet (or Income Statement) - Exchange Rate" report. In the EHI model, the report is titled "Detailed Balance Sheet (or Income Statement) - Original and Target Currency."

Balance sheet:

Assets are listed in descending order of liquidity in two sections, current and noncurrent. Liabilities are shown in the order in which they are to be paid, again broken down into current and noncurrent sections. Trade payables, short-term bank debt and accruals should be shown in that order in the current section. Stockholders' equity has permanent (or legal) capital shown first followed by appropriated retained earnings and unappropriated retained earnings. Small accounts should be consolidated, say up to 5% or 10%, which will not result in materiality considerations. Listing every single account makes the software-generated statement of cash flows almost unreadable.

Assets

Current assets

Assets are defined as current if they will be converted to cash (receivables) or sold or consumed (inventory) within one year of the balance sheet date. There's a concept, not seen much in practice if ever, called the normal operating cycle of a business, from purchase or manufacture to collection for a sale, which for instance might be fifteen months or longer. Assets sold or consumed during the fifteen-month period would be considered current assets.

- Cash and marketable securities - The two accounts can be combined or shown separately. The year-end cash balance can be easily manipulated by deferring temporarily payment of trade and other creditors and accrued expenses and by drawing on short-term working capital lines. Don't spread an overdraft account as a negative cash account. Instead cash should be zero and an overdraft liability account should be created. To be classified as

a current asset, marketable securities by definition must be easily sellable. You should look at the footnotes for possible availability restrictions for both cash and marketable securities. If there are, conservatism would dictate classifying them as noncurrent. Equity securities and debt instruments should be classified as current assets only if the company's intention is to sell them within one year. You should consider if such securities might be long-term investments in related companies.

- Receivables (trade) - The nature of the receivables should be disclosed, trade or due from related parties or stockholders. If they are not trade or, in the case of related party receivables, trade related, and the statements are audited, the theory is that they will be collected within one year. The same comment applies to "other" receivables.

- Related party receivables - They should shown as a separate line item. Depending on whether they are trade related or are loans, they should be placed in a line item in the spread which results in their classification as an operating or financing activity, respectively. If they are not trade related, consider classifying them as noncurrent since they might in effect be long-term investments. The allowance for uncollectible accounts, if known, should be disclosed in the spread.

- Other receivables - The comments in the previous section also apply to other receivables.

- Stock subscriptions receivable - This rarely seen account results from capital that has been subscribed but not paid in yet. There will be an offsetting subscribed capital account in the equity section. The relevant ratios should be recalculated after this account is subtracted from stockholders' equity unless you are convinced the receivable will be collected.

- Notes receivable - If the notes are trade related, they should be placed in a line item that results in their being considered an operating activity in the cash flow statement as opposed to an investing activity.

- Inventory - A breakdown is sometimes in order: raw

materials used in a manufacturing process, work in process and finished goods available for sale. Large changes in any category should be questioned. The balances for raw materials and work in process should be fairly low. There may be an allowance for obsolete inventory which should be disclosed in the spread.

- Advances to suppliers - These advances result from up-front deposits made to suppliers. If the balance is high, relates to inventory suppliers, and trade credit is low, this may not be a good sign. Trade credit may not be available in adequate amounts. If it's an advance to a fixed asset supplier, it should be classified as a noncurrent asset since it will be converted to a fixed asset account, not inventory. This account can be an operating (inventory) or investing (fixed asset) activity.
- Work in process ("WIP") - The formal account title is costs and estimated earnings (or losses) in excess of related billings on construction in progress. This is an inventory account which is seen in construction company balance sheets. As the contractor accumulates costs in the form of direct material, direct labor and depreciation on construction machinery, those costs are debited to this account. When a invoice is submitted, the offsetting credit is to "billings on contracts" which is netted against this account, thus the phrase "in excess of related billings." WIP and the billings account are not removed from the balance sheet until the contract is completed under both the completed contract and percentage of completion methods. You only see "and estimated earnings (or losses)" under the percentage of completion method. A company could have two sets of contracts, one where costs exceed billings and another where billings exceed costs. Because of disclosure considerations the two figures are not netted against each other. A large figure for WIP means that the company isn't able to bill on a timely basis, should be compared to receivables, revenues and direct expenses and possibly questioned. Finally, we see a fair amount of construction companies that don't have a WIP account which means that, rather than an incredibly efficient billing process, WIP is probably being incorrectly debited directly to receivables before an invoice is submitted. Retention is the holdback of a portion of a receivable - say 10% - until the contract or a contract

milestone is completed. Retention can be disclosed in the balance sheet or in a footnote.

- Prepaid expenses - These are costs such as prepaid rent that have been paid but not expensed yet. Financial Analyst says that prepaid expenses should be classified as noncurrent on the theory that they don't convert to cash. They do however obviate the need for cash in the near future, so in an ongoing business they should be classified as a current asset.

- Deposits - See above account on advances to suppliers which this account could also represent. If the account is large and its nature is uncertain, ask about it because its placement affects cash flow and if it doesn't relate to inventory or fixed assets, its recoverability could be questionable.

- Deferred taxation and income tax receivable (for refunds) - They're two separate accounts. We probably see deferred taxation only in Mexico. There can be current and deferred portions and an asset or a liability. Deferred taxation is covered in greater detail in the liabilities section.

- V.A.T. (valued added tax) - This is employed in Mexico, Argentina and other countries. When an item is purchased, V.A.T. is assessed by the seller and should be recorded as a separate asset account by the purchaser. Likewise the seller assesses V.A.T. on its sales and should record that as a separate liability.

- "Other" assets - Details should be requested if the amount is large. It could be anything. Depending on the nature of these assets, consider spreading them as noncurrent.

Noncurrent assets

- Property (land), plant (buildings) and equipment - The three accounts should be broken down if possible, because we see some very high balances for land and buildings. Land and buildings of a closely held company may have been contributed by the stockholders at inflated values in exchange for shares or another contributed capital account. For a manufacturing company, equipment used in

the manufacturing process, if detailed, should be disclosed separately so we can compare the purchase of new equipment that we're asked to support to existing equipment. Accumulated depreciation should also be shown in the spread. Interest paid or accrued during a construction period can be capitalized until the asset in question is put into use at which time it is depreciated at the same rate as the corresponding asset.

- Revaluation of fixed assets - It's allowed by I.A.S. 16 (March 1982) outside of I.A.S. 29 (origins date to April 1989), but we've been told revaluations outside of Bulletin B-10 in Mexico haven't been allowed since 1/1/97. I.A.S. 29 stipulates comprehensive inflation accounting techniques when the cumulative inflation rate over a three-year period reaches or approaches 100% and B-10 is currently required in Mexico in spite of a much reduced inflation rate in recent years. In the absence of comprehensive inflation accounting, if fixed assets are still revalued, the amount should be considered, both for acceptance by the local accounting profession and reasonableness. If it's not allowed by local GAAP, consider whether or not it might be reasonable anyway because of a recent high inflation rate.

- Leased assets - If you see them on the balance sheet, this means a capital lease as opposed to an operating lease. The depreciation rate is based on the useful life of the asset because ownership normally transfers to the lessee at the end of the lease.

- Deferred charges - By definition they are prepaid expenses that won't be recognized within one year and should be rare.
  The most often seen deferred charge is organization costs (legal and other fees to start a business).

- Goodwill and "badwill" - Goodwill is an intangible asset. Badwill is extremely rare and both can only be created through a consolidation - but not a combination - process and only with a purchase, but not with a pooling of interests. In the U.S. poolings have not been allowed since the issuance of SFAS 141 for business combinations effected after 6/30/01. I won't go into the background on the F.A.S.B.'s reasoning. You don't just decide that

a patent, trademark or the company itself is worth $5 million and put that figure on the balance sheet as goodwill with an offsetting credit to an equity account. Like SFAS 142 (effective June 2001 for goodwill), IFRS 3 (March 2004) discontinued the practice of annual amortization of goodwill and requires instead an annual evaluation of possible impairment of goodwill and subsequent write-off.

- Intangible assets - They have no physical presence, represent an economic benefit for a company or they would be written off, and their useful life can be difficult to determine. Some intangible assets can be sold including computer software, patents, copyrights, trademarks and franchise fees. Others like deferred charges, startup costs and leasehold improvements cannot.

Liabilities

- Current liabilities are those expected to be paid within one year of the balance sheet date. See also previous comment under current assets on the normal operating cycle of a business.

- Accounts payable should be listed first because they will probably have a shorter term than bank debt and other short-term liabilities.

- Bank debt and bank overdraft facilities should be listed next and separately. An overdraft facility is a financing activity and should be entered in “overdraft/interest-bearing” in Financial Analyst.

- Accrued expenses - Accrued expenses have been incurred and should be recognized but haven’t been paid yet. Examples are accrued but unpaid interest and salary/wage expenses. High balances may mean these expenses aren’t being paid on a timely basis.

- Current portion of long-term debt - This is a struggle in almost all countries because, except for Mexico, we always have to ask for it. Most of the time - Argentina is one example - it’s included in short-term bank debt. Disclosure is required by U.S. GAAP and I.A.S.

- Advances from suppliers - Should be classified as current

since they will be settled with the delivery of inventory unless they're high value items that won't be manufactured and delivered within one year. An advance from an inventory supplier is an operating activity; for manufacturing equipment it's a financing activity.

- Lease obligations - As with leased assets, if it's on the balance sheet, this means it's a capital lease. There should be current and non-current portions.

- Notes payable - If the amount is large compared to other liability accounts, find out who the lender is, a bank, supplier or a shareholder, and so note in the spread, i.e., "note payable - shareholder."

- Subordinated debt - If it exists and is disclosed, provide details in the memo.

- Deferred taxation - It's done because of tax and financial accounting timing differences and disclosure is required in the U.S. and by I.A.S. Deferred taxation can be either an asset or liability account, with the latter being the most common. An example is straight-line depreciation for financial accounting purposes versus accelerated depreciation for tax purposes. Accelerated depreciation could result in a current tax liability of $500, whereas the eventual tax liability based on a straight-line calculation would be $700. Income tax expense for financial accounting purposes is $700 with the balance sheet showing $500 due as a current liability and $200 being reported as deferred.

- Provisions - They could include warranty expense, maintenance expense for a long-lived fixed asset such as an aircraft engine, or severance benefits. A provision, with the debit being to an expense account, is required by the matching principle. In theory, there could be current and noncurrent portions. Another situation which could either be provisioned or mentioned in a footnote is a pending lawsuit. The lack of a provision however is possible even though it might be warranted, because the company would be tipping its hand on the amount it might be willing to settle for.

- "Other" liabilities, whether current or noncurrent,

should be included in a separate category rather than combined with another account.

- Loans from stockholders - They should be disclosed as a separate item. If they are formally subordinated to the debt Eximbank is supporting, they can be considered as equity in calculating the medium-term performance standards.

- Unearned revenue - This would normally be a current liability. Magazine or newspaper subscriptions paid in advance are an example.

Stockholders' equity

- Contributed (also called paid-in) capital should be listed first and consists of the par value of common stock issued, capital in excess of par value, and donated capital for which no shares were issued. We rarely see capital in excess of par value or donated capital, so there will be a single account which should be labeled capital stock.

- "Other contributed capital" - Don't assume the offsetting account is cash. The offset could be assets that were contributed to a closely held business by the stockholders at inflated values. In Mexico this account is not considered permanent capital and withdrawals can be made from it.

- Subscribed capital - See related section under current assets.

- Proprietorships and partnerships - Common practice is one equity account labeled proprietor's or partners' capital. For disclosure reasons a separate schedule is prepared which

  shows beginning capital, net income, withdrawals, additional capital contributions and ending capital.

- Revaluation reserve - This is an offset to a revaluation of fixed assets which was discussed in the assets section. It should be considered permanent capital, otherwise the purpose of revaluing fixed assets - preserving

capital - is defeated. Depreciation of the revalued portion should be debited to an expense account, not to this account which occurs in some countries.

- Retained earnings - These are accumulated earnings net of cash or stock dividends. There can be appropriated and unappropriated retained earnings. The latter would be rare in the companies we deal with and, in any event, can be converted back to unappropriated by the board of directors.
  If retained earnings doesn't reconcile from year to year, an "unexplained adjustment to retained earnings" comment will appear at the bottom of the income statement spread with the amount. The reasons and amounts should be determined and entered in a section for that purpose at the bottom of the income statement. It could be caused by cash or stock dividends, an allocation to legal reserve, a prior period adjustment (rare), or the prior year's statements not being adjusted to end-of-the-second-year equivalents.

- Legal reserve (an appropriated retained earnings account) - It's required by law in many countries, is based on a percentage of net income up to a specified limit, and can be converted to shares.

- "Reserves" - This could be a revaluation reserve or appropriated retained earnings for a specific or no specific purpose. If large, the exact nature should be determined.

- Treasury stock - We will rarely see this account, which has a debit balance, in a closely held company.

- Minority interest - Minority interest is the minority stockholders' share of the consolidated assets and liabilities. It will be seen as a liability, between liabilities and stockholders' equity or as part of stockholders' equity. It's the latter. Minority interest will also be shown in the income statement.

Contingent liabilities/off-balance sheet items:

Contingent liabilities should be noted in the spreads. In Moody's Financial Analyst, they can be noted in the "Statistics" section.

Income statement:

- Disclosure - There are very few prescribed requirements other than: extraordinary items, unusual or infrequent items, results of discontinued operations, and the effects of a change in accounting principle. If the company is engaged in different sales activities and countries, a breakout is in order. In the U.S. this so-called "segment information" is required.

- Cost of goods sold (which includes cost of goods manufactured for a manufacturing company) - We rarely see a detailed cost of goods sold schedule which would include CGM. CGM consists of direct material, direct labor and indirect manufacturing costs (factory overhead) with the latter being primarily depreciation expense on manufacturing equipment.

- Selling, general and administrative expenses (SG&A) are those normal, ongoing, operating expenses that are necessary to run a business which can be included in a single line item.

- Depreciation expense - For a wholesaler or a retailer, it's an operating expense. For a manufacturer it's both an operating expense and part of CGS, but a breakdown is rarely given, so it should be reported in the spread as part of CGS because most of it will be a manufacturing expense.

- "Other" income and expense - Spread below operating income.

- Gains and losses - These should also be spread below operating income.

- Interest expense - Sometimes it's reported net of interest income. Interest expense and income should be spread separately.

- Foreign exchange gains and losses are also nonoperating. They are not extraordinary items with the exception that

a large, one-time devaluation could be considered extraordinary. There will always be realized and unrealized portions of f/x gains and losses. They are rarely disclosed. If a currency has been devalued, e.g. Dominican Republic in 2003, consider asking for the unrealized portion and show both portions separately in the income statement. The unrealized portion will be added back (loss) or
subtracted (gain) from operating cash flow. Also consider when the unrealized portion comes due.

- Monetary correction - The formal name is purchasing power loss (or gain) on net monetary items. It only appears in statements that have been subject to comprehensive inflation accounting adjustments such as prescribed by Bulletin B-10 in Mexico or I.A.S. 29. It is a measure of the gain or loss experienced by a company because of inflation. The amount depends on the relationship between monetary assets and liabilities and the changes to them during the year and the adjustment of the income statement to end-of-the-year equivalents. The key point is that this account does not affect cash flow, so it should be entered in a line that does not result in an entry in the operating section of the statement of cash flows. In the simplest terms, if a company had only one asset, cash of 100 pesos at the beginning and end of the year, there were no transactions, and the inflation rate was 20%, it should have 120 pesos at the end of the year to keep up with inflation. Since it has only 20, it has had a purchasing power loss of 20 pesos.

- Extraordinary items - Also spread below operating income. To be considered extraordinary, a transaction or event must be both unusual and of infrequent occurrence considering the environment in which the company operates.

- Deferred taxation - Proper disclosure would show income tax expense broken down into the amounts currently due and deferred. This topic is further discussed in the liability section.

Statement of cash flows:

Since this statement is generated by Moody’s Financial Analyst and most other spreading software, a discussion of the

three components of the statement is in order. Investing activities consist primarily of the acquisition and disposal of property, plant and equipment and to a lesser extent loans and long-term investments. Financing activities include loans from unrelated parties, additional contributed capital and dividends. Operating activities are defined by SFAS 95 (July 1988) as all other activities not specifically defined as investing or financing activities, or more specifically those activities and accounts that involve the primary operations of a company which would be the production and sale of goods and services, principally inventory, receivables, trade payables, and wages and salaries. I recommend SFAS 95, paragraphs 14-24 for a more elaborate explanation.

With high quality audited statements, the assumption is that the cash from operations figure is accurate. One of the most important comments in this entire paper is compare the software-generated cash flow figure to the figure in the original statement of cash flows. Also, the software just picks up the changes that it sees in the balance sheet, so stock dividends, revaluations of fixed assets, and fixed assets acquired with debt will not be correctly reported in the software-generated statement. Adjustments and changes in the spreads can and should be made so that the software generated statement is the same or almost the same as the original statement. In some cases, adjustments may not be possible, so certain items will need to be noted manually in the spread or mentioned in the narrative. Also, the software gives you flexibility over which line item you place an account, so a financing activity might incorrectly be shown in the statement as an operating activity. See “General comments,” item F at the beginning of this memo to determine which activity will be affected by an account. Differences in the two figures may further be explained by reviewing relevant footnotes and the statement of changes in stockholders’ equity assuming there is one.