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Tax Return & Cash Flow Analysis

South Carolina Bankers School
July 15, 2026
Luke Sears, CPA

1

Course Goals

- Understand IRS entities and related tax forms
- Identify available cash to service potential loan
- Explanation of cash and non-cash items in tax returns
- Explanation of recurring and non-recurring cash flow
- Calculate debt service coverage
- Examine loan funding case studies

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About Your Instructor

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3

Accessing Tax Forms

- Over 1,000 official tax forms and schedule
- All are accessible on irs.gov → Forms → Search
- Instructions provided for all forms and schedules

Line 21

Student Loan Interest Deduction

You can take this deduction only if all of the following apply.

- You paid interest in 2025 on a qualified student loan (defined later).
- Your filing status is any status except married filing separately.
- Your modified adjusted gross income (AGI) is less than $100,000 if single, head of household, or qualifying surviving spouse; $200,000 if married filing jointly. Use lines 2 through 4 of the worksheet in these instructions to figure your modified AGI.
- You, or your spouse if filing jointly, aren't claimed as a dependent on someone else's (such as your parent's) 2025 tax return.

Don't include any amount paid from a distribution of earnings made from a qualified tuition program (QTP) after 2018 to the extent the earnings are treated as tax free because they were used to pay student loan interest.

Use the worksheet in these instructions to figure your student loan interest deduction.

Exception. Use Pub. 970 instead of the worksheet in these instructions to figure your student loan interest deduction if you file Form 2555 or 4563, or you exclude income from sources within Puerto Rico.

Qualified student loan. A qualified student loan is any loan you took out to pay the qualified higher education expenses for any of the following individuals who were eligible students.

1. Yourself or your spouse.

Chart A—For Most People

IF your filing status is . . .	AND at the end of 2025 you were* . . .	THEN file a return if your gross income** was at least . . .
Single	under 65 65 or older	$15,750 17,750
Married filing jointly***	under 65 (both spouses) 65 or older (one spouse) 65 or older (both spouses)	$31,500 33,100 34,700
Married filing separately	any age	$5
Head of household	under 65 65 or older	$23,625 25,625
Qualifying surviving spouse	under 65 65 or older	$31,500 33,100

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Types of Tax Returns

- Individual – Form 1040 (Includes sole proprietor)
- Limited Liability Company (LLC) – Typically Form 1120, but multiple
- Partnership – Form 1065
- Trusts and Estates – Form 1041
- Charities & Nonprofits – Form 990
- S Corporation – Form 1120S

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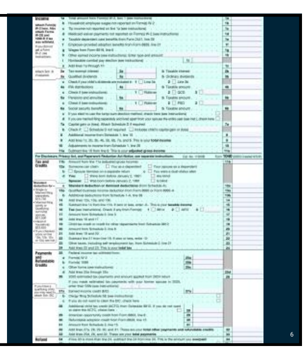
Form 1040

- Disaggregated by income, taxes/credits, and payments
- Income section tells the story
- Salaries, Interest/Dividends, Social Security, Capital Gains, Schedule 1
- Example – Trade business owner (S Corp)
- Line 1 could be $0 or negligible
  - Does not mean not cash flow worthy



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Passthrough Entity

- Pertains to S Corporations, partnerships, trusts and estates
- Income/Loss from business 'flows through' to personal returns

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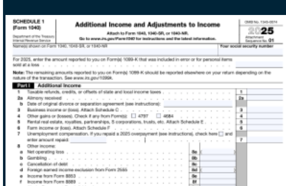
Form 1040 – Schedule 1

- 'Catch-all' schedule
- Line 3 and Line 5 are most common
- Trade business owner with multiple shareholders – Line 5
  - Also - rental income from investment properties
- Sole Proprietor (Practicing CPA) – Line 3


SCHEDULE 1 (Form 1040)
Department of the Treasury Internal Revenue Service

Additional Income and Adjustments to Income

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074
2025
Attachment Sequence No. 01

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | Your social security number

For 2025, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss

Note: The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See www.irs.gov/1099k.

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1
2a	Alimony received	2a
b	Date of original divorce or separation agreement (see instructions):	
3	Business income or (loss). Attach Schedule C	3
4	Other gains or (losses). Check if any from Form(s): ☐ 4797 ☐ 4684	4
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5
6	Farm income or (loss). Attach Schedule F	6
7	Unemployment compensation. If you repaid a 2025 overpayment (see instructions), check here ☐ and enter amount repaid	7
8	Other income:	
a	Net operating loss	8a
b	Gambling	8b
c	Cancellation of debt	8c
d	Foreign earned income exclusion from Form 2555	8d
e	Income from Form 8853	8e
f	Income from Form 8889	8f
g	Alaska Permanent Fund dividends	8g

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Personal Income Examples

Salaried Employee
- Issued W2
- Line 1 on Form 1040
- No supplemental schedules
- Most common scenario

Business Owner (S-Corp)
- Issued K-1
- Allocation = ownership
- Line 8 on 1040
- Includes Schedule 1
- Line 5
- Includes Schedule E

Stock Market Investor
- Buying and selling stocks
- Line 7 on 1040
- One sale = Form 8949
- Form 8949 = Schedule D
- Uncommon (unless you watch reality TV)

Sole Proprietor
- Singular owner
- Typically, also applies to independent contractor
- Line 8 on 1040
- Includes Schedule 1
- Line 3
- Includes Schedule C

- Key Takeaway – Unless 1040 includes only Line 1 income, you will probably need to investigate further

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LLC Background

The Birth of the LLC

The concept of the LLC was born out of a need for a business structure that combined the liability protection of a corporation with the operational flexibility and tax advantages of a sole proprietorship or partnership. The LLC structure was first introduced in the United States in Wyoming in 1977.

Wyoming's legislature enacted the first LLC statute, largely influenced by similar business structures in other countries, particularly the German GmbH (Geselischaft mit beschränkter Haftung).

The Spread and Evolution of LLCs

Following Wyoming's lead, other states began to adopt LLC statutes. Florida was the second state to pass LLC legislation in 1982. However, it wasn't until the Internal Revenue Service (IRS) issued Revenue Ruling 88-76 in 1988 that LLCs gained significant traction. This ruling allowed LLCs to be treated as partnerships for federal tax purposes, provided they met certain criteria, thus avoiding double taxation.

By The Mid-1990s, All 50 States Had Enacted LLC Legislation, And The LLC Became A Widely Recognized And Utilized Business Structure Across The Country.

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10

LLC Background

- LLCs created and regulated under laws of each state
- Tax election made in 1st year a return is filed
- IRS does not recognize 'Single Member LLC'

LLC Entity Classifications upon making 1st year tax elections

	Partnership election	C Corporation election	S Corporation election	Single member LLC
Tax form	1065	1120	1120 S	Schedule C
				Schedule E
				Schedule F

IRS refers to Single Member LLC as "disregarded entity"

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11

Corporation – Form 1120

- Company or group of people acting as single entity
- Steps in SC for corporate formation
  - Choose name and clear name with SC Secretary of State
  - Decide on registered agent
  - File Articles of incorporation (~33-2-102)
    - Must contain a certificate, signed by an attorney licensed to practice is SC
  - File initial annual report (CL-1)
  - Establish Bylaws & Corporate Records
  - Appoint Initial Directors & Hold Organizational meeting
  - Get ID numbers (IRS-SC) and issue stock certificates

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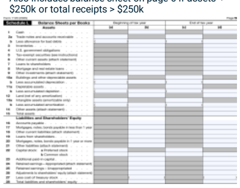
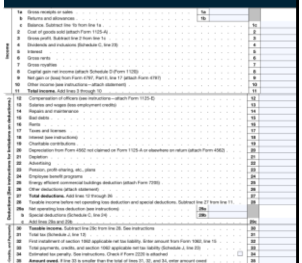
12

Form 1120

- Appears much like a business financial statement
- Shows final taxable income on page 1 (i.e. net profit)
- Included supplemental schedules – not overly relevant to cash flow decision making
- Also includes balance sheet on page 6 if assets > $250k or total receipts > $250k





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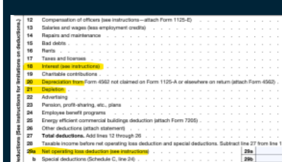
Form 1120 – Non-cash items / Add-backs

- Lines in expense section that do not have actual cash impact
- Depreciation, depletion, NOL
- These should be 'added-back' in evaluating cash flow
- Interest – Want to avoid double counting so also 'added-back'
- Will dive into this in more detail later



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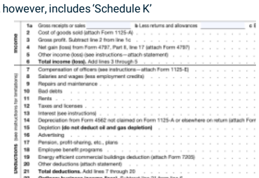
S Corporation – Form 1120-S

- 'Pass-through' – Shareholders assume income, losses, deductions, credits to their own individual returns
- S Corporations limited to 100 shareholders
- Family members who are individual shareholders can be counted as one singular shareholder
- Similar to Form 1120, however, includes 'Schedule K'



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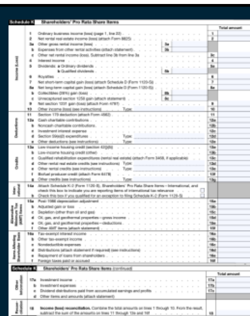
S Corporation – Form 1120-S

- Schedule K is identical to full business summary on page 1
- Line 1 shows allocation to shareholder of business income/loss
- This still does not paint full picture in determining individual's cash flow



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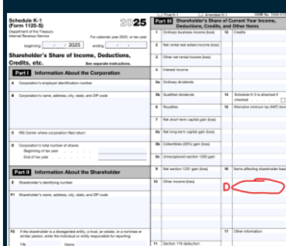
16

S Corporation – Form K-1

- Schedule K is identical to full business summary on page 1
- Line 1 shows allocation to shareholder of business income/loss
- This still does not paint full picture on determining individual's cash flow
- Was there a distribution (i.e. cash) to shareholder during the year?



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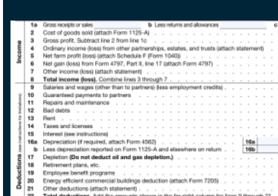
Partnership– Form 1065

- Two or more parties that manage and operate business and share profits and losses
- Partners are personally liable for debt and obligations of partnership
- Similar to S Corp – Form K-1 and items 'flow-through' to individual partners' 1040
- Not all K-1's are made equal…



Income
1a Gross receipts or sales b Less returns and allowances c
2 Cost of goods sold (attach Form 1125-A)
3 Gross profit. Subtract line 2 from line 1c
4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)
5 Net farm profit (loss) (attach Schedule F (Form 1040))
6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)
7 Other income (loss) (attach statement)
8 **Total income (loss).** Combine lines 3 through 7

Deductions (see instructions for limitations)
9 Salaries and wages (other than to partners) (less employment credits)
10 Guaranteed payments to partners
11 Repairs and maintenance
12 Bad debts
13 Rent
14 Taxes and licenses
15 Interest (see instructions)
16a Depreciation (if required, attach Form 4562) 16a
b Less depreciation reported on Form 1125-A and elsewhere on return 16b
17 Depletion **(Do not deduct oil and gas depletion.)**
18 Retirement plans, etc.
19 Employee benefit programs
20 Energy efficient commercial buildings deduction (attach Form 7205)
21 Other deductions (attach statement)
22 **Total deductions.** Add the amounts shown in the far right column for lines 9 through 21
23 **Ordinary business income (loss).** Subtract line 22 from line 8

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18

K-1 Differences for Cash Flow Evaluation

- Generally, S Corp K-1's are considered more relevant for cash flow purposes
- Shareholders control distributions; partnership distributions typically hampered by partnership agreements
- Difficult to gauge recurring/non-recurring distributions in a partnership
- Shareholders have ability to outlay cash for personal reasons (i.e. payments on a personal loan)

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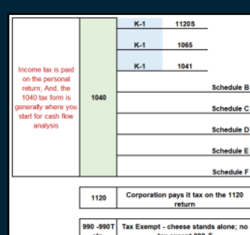
19

19

Tax Return Connectivity

- Multiple sources of income on single 1040
- Where is the cash flow coming from?
- Understand your customer's business
- What is going to be the primary source of repayment on the prospective loan?



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20

20

Cash Basis Accounting

- Income and expense recorded with exchanges of cash
- No accounts receivable or accounts payable
- Excellent evaluator of repayment ability for borrower
- Typically used by small partnerships and S corps

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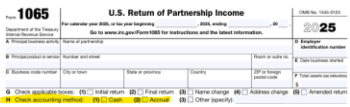
Accrual Basis Accounting

- Income and expense recorded with when services earned/provided
- Example – Perform work in December, payment in January
  - Income is recorded in December under accrual basis, January for cash basis
- More difficult evaluation of cash flow
- Evaluate accounts receivable and accounts payable


Form 1065 U.S. Return of Partnership Income OMB No. 1545-0123 2025
Department of the Treasury Internal Revenue Service
For calendar year 2025, or tax year beginning , 2025, ending , 20 .
Go to www.irs.gov/Form1065 for instructions and the latest information.
A Principal business activity | Name of partnership | D Employer identification number
B Principal product or service | Number and street | Room or suite no. | E Date business started
C Business code number | City or town | State or province | Country | ZIP or foreign postal code | F Total assets (see instructions) $
G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return
H Check accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify):

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Why Does This Matter?

- Cash method (1) – Taxable income triggers regardless of cash distributions to owner
  - Taxable income ≠ individual cash flow
- Cash method (2) – Taxable income = cash distributed = cash to be used for debt service calculation
- Accrual method (3) – Sales are recorded but no cash received; taxpayer must still report taxable income even with no cash received

Accounting method and taxable income examples for pass throughs
Assumes 1st year operations for simplicity & only one owner

	Cash method (1)	Cash method (2)	Accrual method (3)
Balance Sheet			
Cash in Bank	$ 150,000	$ 150,000	$ -
Accounts Receivable	100,000	100,000	100,000
Total Assets	250,000	250,000	100,000
Income Statement			
Sales	$ 150,000	$ 150,000	$ 100,000
Net income	$ 150,000	$ 150,000	$ 100,000
Other Facts			
Cash distributions to owner	No cash distributed (draw)	$ 150,000	None - no cash to distribute
Taxable income	$ 150,000	$ 150,000	$ 100,000
Amount to be used for debt service calculation	0.00	$ 150,000	0.00

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Tax Return Analysis Conclusion

- Taxable income does not always equal cash flow
- Cash flow is not necessarily taxable
- Imperative to identify the recurring cash flow for a prospective customer
- Where is the cash flow coming from?

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Questions?

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Recurring vs. Non-recurring

- Recurring – Continuous, predictable, what we want
- Non-recurring – Unique, unpredictable, not a quality indicator of repayment over time

Recurring:	Non-recurring:
• Wages	• **Capital gains**
• Rents	• Insurance proceeds
• Business income	• Settlement income

- Capital gains – Line 7 (Schedule D) on Form 1040; typically, sale of investments
- Remove non-recurring income from cash flow calculation

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26

Recurring vs. Non-recurring

- Put yourself in customer's shoes – there can be a LOT of documentation
- Be intentional with your additional requests and prepared ahead of time with pointed questions
- Green flag – K-1 income with consistent distributions over several years, majority ownership/managing partner
  - Professional services, trade businesses, rental real estate
- Red flag – Capital gain in single year, debt financed income, NOL utilization
- Can also be applied to expenses, not just income
  - Lawsuit, building damages, start-up costs

K-1 Type	Credit Reliability
Owner-operator S-corp	**High**
Closely held operating partnership	Moderate
Minority partnership / PE / RE fund	**Low**
Investment partnership with distributions	Case-by-case
One-time deal / liquidation	**Non-recurring**

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27

Cash Flow Calculation Basics

- Debt Service – Payments made on outstanding obligations, including prospective loan (annual principal and interest)
- CADS – Cash available for debt service
- Business Metric: EBITDA – Earnings before income, taxes, depreciation, amortization
  - Here come the 'add-backs' discussed earlier. Eliminates non-cash and avoids double counting
- Consumer Metric: DTI – Debt to income
  - Debt obligations / gross income
- DSC or DSCR – Debt service coverage ratio (CADS / Debt Service)
  - This is ultimate measure and provides quantitative metric for final evaluation

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28

Cash Flow Calculation Basics

- What is acceptable? Depends on your institution and loan type
  - General rule of thumb, above 1.2x is considered adequate for business
  - Ideal consumer customer < 30% DTI, can be up to < 45% in some instances
- What is the primary source of income?
  - Easy to get overwhelmed with data but this can be best identified with conversation with prospective customer
- What are the earnings trends? Ideal to obtain the last three year's returns
- Business Loan – Can there be multiple sources of income?
- Global Debt Service Coverage (GDSC) – Is valuable and useful but should NOT be the only measure

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29

Global Cash Flow

- Example – ABC LLC wants $300,000 business loan to expand landscaping business
  - Business has only operated for one full year
- Primary source of repayment – landscaping
- 'Stand-alone' (Business) DSC is marginal
- Guarantor has successful investment real estate portfolio
- When evaluated globally, prospective relationship looks strong and capable of repayment
- What other factors should be considered?

Proposed Loan Terms		
Principal	300,000	
Rate	6%	
Amort (Months)	180	
Monthly Payment	2,532	
Total Debt Service	30,379	[a]
ABC LLC Year 1 EBITDA	25,000	[b]
DSC	0.82	[b] / [a]
Guarantor		
1040 W2	75,000	
1040 Sch. E	275,000	
Total Guarantor CADS	350,000	[c]
1st Mortgage ADS	42,000	
Mortgages on Inv RE	125,000	
Total Debt Service	167,000	[d]
Personal DSC	2.10	[c] / [d]
Global		
CADS	375,000	[c] + [b]
Debt Service	197,379	[a] + [d]
GDSC	1.90	

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30

Case Study #1

- Purpose: Purchase recreational boat

Case Study #1 – Income

- Receive prospective customer's Form 1040
- Identify the sources of income from last tax year
  - Need more information than just AGI
- What would we consider recurring?
- Would there be additional income information we would want to see?
- Should those K-1's be treated the same?
  - Assume S-Corp distribution is recurring
  - Assume Partnership distribution is NOT
- What would be our final calculation of cash flow?

Proposed Loan Terms

Purchase Price, net of down payment	$	175,000	
Rate		6.75%	
Am Period (Months)		84	
Monthly Payment		2,619.88	
Annual Debt Service	$	31,438.56	

Borrower Form 1040

W-2	120,000	Line 1
Capital Gain	40,000	Line 7 (Sch. D)
Schedule 1	140,000	Line 8
AGI	300,000	

Note - When we review Schedule 1 on the borrower's return, we see the full $140,000 is in Line 5, indicating either rental real estate, partnership, S corp, etc.

Sch. E (Part II - Income or Loss from Partnership or S Corp)

Consulting Business	80,000	100% owned S Corp
Investment Company	60,000	25% owned Partnership

Sch. D (Short and Long Term Capital Gains and Losses)

Asset Sale Gain	40,000	Sold personally held stocks

K-1s

S-Corp Distribution	70,000
Partnership Distribution	30,000

Cash Flow Summary

Recurring Wages		120,000	100% of W2
Recurring S-Corp Dist.		70,000	100% of S-Corp Dist.
Weighted Partnership Dist.		10,000	1/3 of Partnership Dist.
CADS	**$**	**200,000**	

Case Study #1 – Debt Service

- Relevant information – Credit report, Personal Financial Statement
- Make educated decision on debt service of other obligations
  - When was mortgage originated? Terms?
  - Living expenses – know your customer
- Scenario 1 – What if the S-Corp distribution was semi-recurring?
- Scenario 2 – What if S-Corp was on cash basis and $80,000 became CADS?
- Other considerations?

Existing Obligations (Payments)

Primary Residence	36,000	Annual
Vehicle Loans	18,000	
Student Loans	6,000	
Proposed Loan Terms	31,439	Boat Loan
Total Long-Term Obligations	91,439	
Debt to Income	**30.48%**	**AGI/Debt**

Cash Flow Evaluation

Living Expenses	50,000	Subjective - 25% CADS
Total Annual Debt Service	141,439	Expenses + Debt Payments
Debt Service Coverage	**1.41**	**CADS/Debt Service**
Scenario 1	**1.17**	**Half of CY Distribution**
Scenario 2	**1.73**	**Include income**

Case Study #2

- Purpose: Expand production facility

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34

Case Study #2 – Income

- Seeking commercial real estate financing
- Company is profitable
- What are the add-backs to get to EBITDA?
- Not all analyses adds back taxes
  - Prior NOLs can offset actual cash payments

Income	1a	Gross receipts or sales	1a 4,000,000		
	b	Returns and allowances	1b 50,000		
	c	Balance. Subtract line 1b from line 1a		1c	3,950,000
	2	Cost of goods sold (attach Form 1125-A)		2	2,700,000
	3	Gross profit. Subtract line 2 from line 1c		3	1,250,000
	4	Dividends and inclusions (Schedule C, line 23)		4	
	5	Interest		5	
	6	Gross rents		6	
	7	Gross royalties		7	
	8	Capital gain net income (attach Schedule D (Form 1120))		8	150,000
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)		9	
	10	Other income (see instructions—attach statement)		10	
	11	**Total income.** Add lines 3 through 10		11	1,400,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E)		12	
	13	Salaries and wages (less employment credits)		13	420,000
	14	Repairs and maintenance		14	65,000
	15	Bad debts		15	10,000
	16	Rents		16	180,000
	17	Taxes and licenses		17	55,000
	18	Interest (see instructions)		18	70,000
	19	Charitable contributions		19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)		20	90,000
	21	Depletion		21	
	22	Advertising		22	
	23	Pension, profit-sharing, etc., plans		23	
	24	Employee benefit programs		24	
	25	Energy efficient commercial buildings deduction (attach Form 7205)		25	
	26	Other deductions (attach statement)		26	260,000
	27	**Total deductions.** Add lines 12 through 26		27	1,150,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11		28	350,000
	29a	Net operating loss deduction (see instructions)	29a		
	b	Special deductions (Schedule C, line 24)	29b		
	c	Add lines 29a and 29b		29c	
	30	**Taxable income.** Subtract line 29c from line 28. See instructions		30	350,000
	31	Total tax (Schedule J, line 12)		31	73,500

EBITDA			
Gross Income		350,000	
Add: Taxes		73,500	**Not always done
Add: Depreciation		90,000	Non-cash
Add: Interest		70,000	Double counting
CADS	$	**583,500**	

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35

35

Case Study #2 – Debt Service

- Different approach than individual
  - Debt schedule to accompany balance sheet is ideal
- How can we evaluate annual debt service on existing notes?

EBITDA			
Gross Income		350,000	
Add: Taxes		73,500	**Not always done
Add: Depreciation		90,000	Non-cash
Add: Interest		70,000	Double counting
CADS	$	**583,500**	

Debt Service		
Outstanding Note		1,400,000
Amortization Period		180
Rate		5.00%
Monthly Payment		11,071.11
Annual Debt Service		132,853
Add: Current Notes		80,000
Total Debt Service	$	**212,853**
Current DSC		**2.74**

Schedule L	Balance Sheets per Books	End of tax year	
	Assets	(c)	(d)
1	Cash		150,000
2a	Trade notes and accounts receivable	450,000	
b	Less allowance for bad debts	(20,000)	430,000
3	Inventories		600,000
4	U.S. government obligations		
5	Tax-exempt securities (see instructions)		
6	Other current assets (attach statement)		100,000
7	Loans to shareholders		
8	Mortgage and real estate loans		
9	Other investments (attach statement)		
10a	Buildings and other depreciable assets	1,400,000	
b	Less accumulated depreciation	(500,000)	900,000
11a	Depletable assets		
b	Less accumulated depletion	( )	
12	Land (net of any amortization)		
13a	Intangible assets (amortizable only)		
b	Less accumulated amortization	( )	
14	Other assets (attach statement)		200,000
15	Total assets		2,400,000
	Liabilities and Shareholders' Equity		
16	Accounts payable		320,000
17	Mortgages, notes, bonds payable in less than 1 year		80,000
18	Other current liabilities (attach statement)		100,000
19	Loans from shareholders		
20	Mortgages, notes, bonds payable in 1 year or more		1,400,000
21	Other liabilities (attach statement)		
22	Capital stock: a Preferred stock	50,000	
	b Common stock		50,000
23	Additional paid-in capital		200,000
24	Retained earnings—Appropriated (attach statement)		
25	Retained earnings—Unappropriated		250,000
26	Adjustments to shareholders' equity (attach statement)		
27	Less cost of treasury stock		( )
28	Total liabilities and shareholders' equity		2,400,000

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36

36

Case Study #2 – Wrap-up

- What terms would we be willing to offer?

Policy Minimum DSC	1.25	
Max Debt Service	466,800	CADS/Min DSC
Additional Capacity	253,947	
Principal	2,750,000	
Amortization Period	240	
Rate	6.50%	
Monthly Payment	20,503	
Annual Debt Service	246,039	
Total Proposed Debt Service	**458,892**	
New DSC	1.27	

- Additional considerations – GDSC, liquidity, AR turnover, financial/industry trends

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37

Key Takeaways

- Imperative to document assumptions in analysis
  - Don't want to leave anyone guessing about how totals were derived
- Err on the side of being conservative
  - Follow your institution's policy
- Understand what documents you need
  - Less is more – WHAT IS PRIMARY SOURCE OF REPAYMENT
- More exposure = more confidence in decision making

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38

Thank you!

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39