

COMMERCIAL LENDING REPORT



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**Does your borrower
need new management?**

Top of the heap

Be aware of the most rampant fraud risk areas

Cash flow statements tell a story

Demystifying deferred taxes

DOES YOUR BORROWER NEED NEW MANAGEMENT?

A borrower is only as strong as the people who run the show. But even the most talented individuals have limited strengths, abilities and stamina. When managerial chores stretch the current owners to their limits, a business may falter.

Lenders who recognize when it's time for a management change can help borrowers streamline the transition and prevent financial turmoil. Evaluating management's strengths and capabilities is one of the most difficult due diligence tasks — but it's also one of the most crucial assessments.

THINK OUTSIDE THE FAMILY

Five years ago, Bob Brown told his lender, Joan Dollar, that he had been diagnosed with terminal cancer and intended to turn over Brown Industries to his twin sons, Bill and Boris.

Joan was understandably concerned — she knew firsthand the failure rate for second-generation owners. To make matters worse, Bill (a high school teacher) and Boris (an advertising executive) lacked the manufacturing experience, technical know-how and fiscal discipline that had made Brown Industries a model borrower for the last 20 years.

Joan had a heart-to-heart discussion with Bob about the future of Brown Industries. Although Bob wanted to see his sons take over the reins, were they truly qualified for the job and willing to dig in? Did Bob want Brown Industries to survive him?

When Bob admitted that his sons weren't optimal successors, he gifted stock to the twins, which provided them with a passive income stream and seats on the company's board of directors. Bob's accountant filled in as interim CEO and assembled a professional management team to handle day-to-day operations.

Although Bob didn't survive his battle with cancer, his legacy lives on through Brown Industries. The

new management team has taken the company to the next level, and it's considering a public offering in 2012.

GO INTO THE TRENCHES

At some point every business outgrows its first-generation entrepreneurs. Perhaps the founder — like Bob — faces health issues. Or perhaps the company reaches a critical mass that exceeds the founder's abilities. When current management is struggling to stay afloat, the owner faces tough choices: Should it bring in a family member, hire more experienced outsiders, or sell to a larger organization? In order to recognize when it's time to upgrade management, lenders need to visit the borrower's premises to get acquainted with the people behind the numbers.



When interviewing owners and managers, consider their ages, health and retirement goals. Evaluate whether the owners are buried in administrative chores and spend less and less time in activities such as brainstorming ideas and selling new accounts.

Ask to see the organizational chart and job descriptions. Every business should have a tiered structure and a viable succession plan. Such planning minimizes the risk of relying too heavily on key people. Also evaluate the qualifications of up-and-coming managers — do they have what it takes to run the show? If not, training and mentoring are in order.

ACT NOW

If a borrower is in the same or similar situation as Bob, it's time to execute a management change or upgrade. Higher-than-average unemployment rates make it an employer's market. And many skilled

but out-of-work managers are eager to jump aboard your borrower's ship.

Lenders and accountants can introduce borrowers to their networks of business contacts, which include, for example, potential CFO, CIO and CEO candidates, business appraisers and brokers, and executive recruiters.

EMBRACE CHANGE

Ownership changes can be a touchy subject. But a changing of the guards needn't be a disruptive process from the owner's *or lender's* perspective, if it's proactively managed before the business enters crisis mode.

Advise borrowers to think of management changes as a rite of passage. How many Fortune 500 companies continue to be run by their original founders, after all? \$

TOP OF THE HEAP

Be aware of the most rampant fraud risk areas

One high-growth sector that every lender wants to *avoid* is the fraud “industry.” Certified Fraud Examiners participating in the Association of Certified Fraud Examiners' 2010 *Report to the Nations on Occupational Fraud and Abuse* estimate that the typical business worldwide loses 5% of its annual revenues to fraud. Applied to the projected 2011 GDP, this 5% figure translates to more than \$760 billion in fraud losses in the United States alone.

When fraud strikes a borrower, that customer's ability to repay debt — and the quality of its collateral — may be severely compromised. Protect yourself from fraud losses by identifying and monitoring high-risk balance sheet accounts.

ACCOUNTS RECEIVABLE

Accounts receivable (A/R) isn't only a common source of collateral; it's also a popular fraud target. The overriding objective when manipulating receivables is to overstate them, which ultimately boosts revenues. Since there's no corresponding expense for the padded revenues, profits also receive an artificial boost from A/R scams.

When misstating receivables, unscrupulous managers might send invoices to nonexistent (phantom) customers or falsify invoices to existing customers. For example, they might invoice without shipping products, double-charge for shipped items or send defective merchandise.

PERFORMANCE ANXIETY AND FRAUD LINK UP

Motive is one of the key ingredients for cooked books. Pressure to achieve unrealistic financial goals often prompts people to misstate or exaggerate financial results.

Incentive-based compensation plans, designed to motivate employees to achieve more, sometimes backfire. Suppose a CFO's annual bonus, for instance, is based on profits. To maximize the bottom line, he or she might:

- * Overstate ending inventory, which minimizes the cost of goods sold (an expense),
- * Understate returns and allowances, which also minimizes the cost of goods sold,
- * Overstate revenues, often without a corresponding charge to the cost of goods sold,
- * Understate accrued expenses, which lowers overall expense deductions, and
- * Manipulate overhead allocations among affiliates.

Performance pressures are greatest in uncertain economic times. Today, more than bonuses are at stake. Managers who fail to achieve goals may lose financing — or their jobs.

When conducting due diligence, ask yourself whether an owner or a manager might feel undue pressure to achieve. If so, fraud may be lurking in the company's financial statements.

Eventually, the errors will be reversed — if customers notice the anomalies. But fraudsters bank on the reversals happening long after year end. Premature revenue recognition schemes also can boost receivables in the current period, but they “steal” revenue from future periods.

A/R manipulation can be monitored through aging schedules, because artificial sales can't be collected. High post-year-end returns and slow turnover often accompany receivables fraud.

You also should monitor the gross margin percentage. Because bogus sales don't incur many costs, a company that achieves a significantly higher gross margin than its competitors sticks out as a potential A/R fraud risk.

INVENTORY

Inventory is an easy place to hide fraud, because it's difficult to audit and is based on subjective estimates. Cost of sales is affected by the amount recorded in ending inventory. That is, the higher the ending inventory, the lower the cost of sales will be. So, by overstating ending inventory, a borrower inflates its collateral base *and* lowers its cost of sales, which increases profits — a win-win for the unscrupulous manager.

Accountants who specialize in a borrower's industry and conduct on-site inventory observations provide some protection against inventory reporting scams. That's because they're watching for the warning signs of inventory manipulation.

Examples of inventory fraud include inflated unit costs, the improper inclusion of “bill and hold” sales and consignment inventory in physical counts, and cutoff fraud, in which sales and costs are incorrectly matched in the current accounting period.

Signs that a borrower may be manipulating its inventory include large increases in inventory compared to sales, cost of sales and accounts payable (A/P). Watch for a decline in the inventory turnover ratio, because nonexistent, obsolete or overvalued items rarely sell. Also monitor insurance expense — a borrower is unlikely to increase insurance coverage for phantom inventory.

ACCOUNTS PAYABLE

Borrowers also can use A/P to temporarily improve financial results or hide asset theft. By understating A/P, the balance sheet appears healthier because it shows less current liabilities. And the income statement shows fewer costs, which boosts profits.

In accrual accounting, the purpose of reporting A/P is to match expenses incurred with revenues earned in the current period. Payables are outstanding balances due to the time lag between receipt of and payment for goods and services. Companies record payables for items such as raw materials, utilities, rent and wages.

Unscrupulous managers may, for example, issue but hold checks, use related vendors at below-market rates, collude with unrelated vendors for a kickback, or apply inconsistent cutoff procedures. Lenders can evaluate payables fraud risks by comparing expenses — especially the gross margin percentage — over time and by evaluating supplier lists for concentration risks and related-party vendors.

HELP — A PHONE CALL AWAY

Audits are a lender's first line of defense. Unfortunately, financial statement audits may not



always reveal fraud if management misrepresents information. Additionally, many borrowers aren't audited by a CPA firm. Savvy lenders familiarize themselves with aspects of the balance sheet that pose the highest fraud risks to better focus their independent due diligence efforts. They also know to contact a forensic accountant, if the statements seem awry. \$

CASH FLOW STATEMENTS TELL A STORY

Lenders who use the statement of cash flows as an assessment tool can gain insight into their customers' financial health, cash management skills and loan worthiness. But they need to understand what they're seeing — or they could draw the wrong conclusions.

HOW ARE THEY STRUCTURED?

Always a component of audited financial statements, the statement of cash flows also might be

available from other financial statement presentations, such as a compilation or borrower-prepared statement. It consists of three sections:

1. Cash flows from operations. This section converts the business's accrual net income to cash provided or used by its operations. All income-related items flow through this part of the statement, such as net income, gains (or losses) on asset sales, depreciation and amortization, and net changes in accounts

receivable, inventory, prepaid assets, accrued expenses and payables.

2. Cash flows from investing activities. The second section of the statement is a primary indicator of solvency. If a company buys or sells property, equipment or marketable securities, the transaction shows up here. This section might reveal that a company is reinvesting in its future operations — or divesting of assets for emergency funds.

An increase in receivables is common for growing businesses, but a mounting receivables balance also might signal cash management inefficiencies.

3. Cash flows from financing activities. This last part reveals your customer's transactions with investors and lenders. It shows the company's ability to access cash via either debt or equity. This segment also indicates how the company leveraged its balance sheet to avoid cash crunches — one indication of how well it might navigate through a sluggish economy.

WHAT SHOULD YOU LOOK FOR?

The statement of cash flows shows changes in balance sheet items from one accounting period to



the next. Make sure you inquire about significant balance changes. For example, if accounts receivable were \$3.5 million in 2009 and \$4.5 million in 2010, the change would be reported as a cash outflow from operations of \$1 million. That's because more money was tied up in receivables in 2010 than in 2009.

An increase in receivables is common for growing businesses, but a mounting receivables balance also might signal cash management inefficiencies. And an aging schedule might reveal significant, potential loss write-offs. This is important information if you're a lender that relies on accounts receivable as collateral. Be specific with the type of business you're analyzing. In some cases — for example, in a retail operation that's dependent on cash sales — receivables shouldn't grow.

Also beware of businesses that continually report negative cash flows from operations. When operating outflows consistently outpace operating inflows, it's time for intervention.

HOW SHOULD YOU REACT TO A TROUBLESOME STATEMENT?

Let's say you spot cash shortages in the statement of cash flows, and you suspect your business customer is struggling operationally. This can impair repayment ability, which hurts the business's credit risk rating with the bank, and subjects the bank to higher reserve balances and added regulatory scrutiny.

You may wish to advise your borrower to consult with their CPA or accountant to identify the trouble areas and provide suggestions to help improve cash flow. A change in business operations may be a hard pill for an entrepreneur to swallow. But in the short term, you'll likely help your customers find some hidden sources of cash.

THE TRUTH BEHIND THE NUMBERS

Don't let the mass of numbers in a cash flow statement turn you off. Although the statement is a collection of figures, this document also can tell you a great deal about your prospective borrowers' ability to manage their finances — and the risk they present to your lending operation. \$

DEMYSTIFYING DEFERRED TAXES

Deferred tax assets and liabilities can confuse just about everyone. When reviewing a borrower's financial statements, you may wonder what they are and how the company quantifies them. Wonder no more.

UNDERSTANDING THE BOOK/TAX ANOMALY

An artificial by-product of book and tax accounting methods, deferred taxes are future taxable amounts or deductions that arise from temporary differences between accounting income and taxable income.

Financial statements prepared under Generally Accepted Accounting Principles (GAAP) require income taxes to be calculated based on GAAP earnings. But in reality, companies pay taxes on their taxable income. Borrowers record a deferred tax asset if they pay more tax than is reflected in their financial statements. If the reverse occurs, a deferred tax liability is reported.

A common reason for differences between GAAP and taxable income is depreciation expense. For tax purposes, companies use accelerated depreciation methods to minimize taxable income in the early years of a fixed asset's life. But they often use straight-line depreciation for GAAP purposes to maximize earnings per share and to minimize artificial fluctuations in earnings.

Differences between GAAP and tax depreciation methods typically result in companies reporting deferred tax *liabilities*, because the actual tax paid is temporarily lower than what's reported on the GAAP income statement.

Deferred tax *assets* frequently result from held-over tax benefits, such as capital loss carryforwards, operating loss carryforwards and tax credit

carryforwards. These items arise because a company lacks taxable income to use the carryforwards in the current period — but the company expects to earn sufficient taxable income to use them in *future* periods.

DETECTING SUBTLETIES

Like all balance sheet accounts, deferred taxes may be current or long-term, depending on whether the borrower expects to use them over the next 12 months. Deferred tax liabilities are recorded at their full amount, without regard to the time value of money.

Deferred tax assets are offset by the possibility that the asset will expire, tax rates will change, or the company won't earn sufficient income to use a carryforward. Each year, borrowers reassess their deferred tax allowances, and any adjustments flow through to the income statement.

You can't always count on deferred taxes. GAAP permits some leeway in how companies report and adjust deferred taxes. And some carryforwards may not be transferable if ownership changes.

CLEAR AS MUD

Lenders should understand every line item on their borrowers' financial statements, including the risks that assets might be overvalued, liabilities might be understated or management might manipulate the numbers for a rosier outlook. \$

