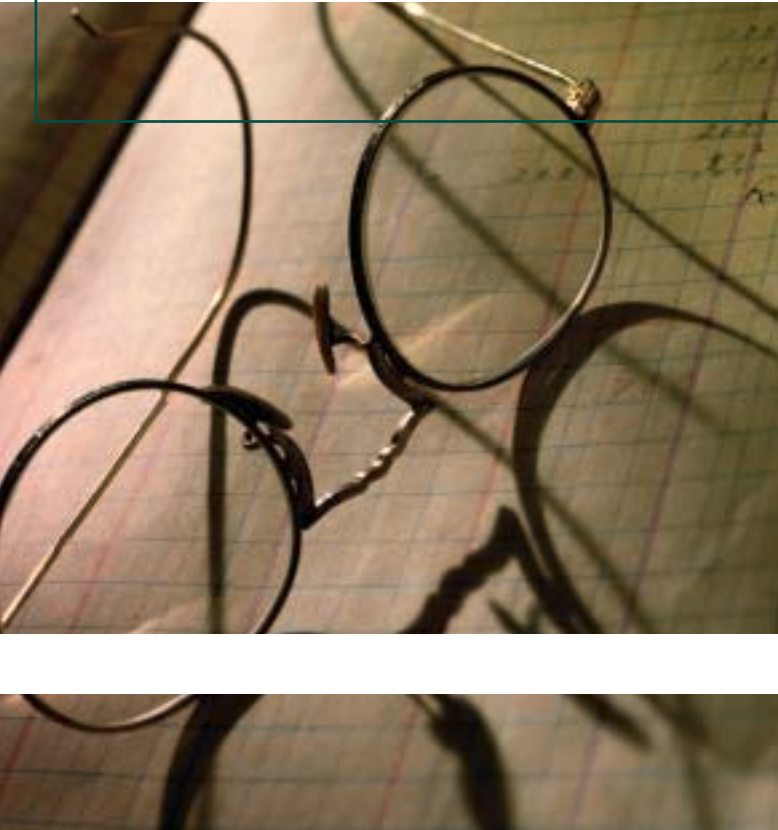


july/august 2003

commercial lending report



FAMILY BUSINESS LOANS: the inside story

How to **SEPARATE**
a company's revenue
fiction from revenue fact

**The case of the lawyer
who asked for a loan**

PLUS!

**Accrual warning signs
of financial ill health**

Simione Macca & Larrow_{LLP}



CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS ADVISORS

“On Balance, We Offer You More.”

175 Capital Boulevard • Rocky Hill, CT 06067
(860) 529-5600 • (800) 493-5605 • FAX (860) 529-5605

4130 Whitney Ave • Hamden, CT 06518
(203) 281-0540 • (800) 493-5605 • FAX (203) 287-6788

Making a Family Business Loan

Is It an Offer You Shouldn't Refuse?

ending to a family business can be like a trip to the movies. You can choose from comedies, dramas and love stories. Sometimes you realize halfway through the show you pick that it isn't what you anticipated. So you leave and ask for your money back. Certainly, when lending to a family business, you have far more at stake than a \$9 movie ticket. So, before you make such a loan, read on.

Listen to The Critics

More than 80% of all North American businesses and 35% of the Fortune 500 companies are family-owned, according to a 2001 article in the *Los Angeles Business Journal*. Given those statistics, your loan portfolio probably includes some family operations. But, do you really know what makes these businesses different from others? Their owners tend to:

- Be hands-on, focusing on the company's internal operations, such as cost containment and product capabilities,
- Manage by gut instinct more than written policies,
- Trust their employees, and
- Set family and community goals as well as financial ones.

These managerial differences can lead to slower growth and lower profits for family firms. But there are ways to find less risky family-owned prospects, as we'll see.

Preview the Coming Attractions

To begin, select seemingly harmonious families with open communication and similar goals among its members. In addition, to offset a family

business's internal focus, remind owners to pay attention to external factors, such as market trends and regulatory changes — especially if the company operates in a volatile industry.

If an owner appears overly trusting of the company's employees, encourage management to adopt adequate internal controls to foil fraud attempts. Furthermore, if you sense a family

business owner is an autocrat who makes decisions viscerally, encourage strategic planning, family meetings and an active board of directors.

Virtually everyone puts his or her best face forward when requesting a bank loan. So, how do you identify harmonious families and an internally focused manager vs. a dissonant family and autocratic owner? To recognize these characteristics, get to know the family behind the business. You can tour the

company's plant and interview the company's lawyer, accountant and as many unrelated employees as possible. After you've done those things, talk to family members and ask them about what you've seen or heard. Their responses to your informed queries will be telling.

Unfortunately, two obstacles may stand in your way. First, the owners may be reluctant to share information with an outsider. Additionally, they may not have time for lunch meetings, plant tours and interviews. So make the most of your limited time. Focus your inquiries on these areas:

Stock ownership. Account for every outstanding share of the company's stock. Periodically inquire about sales, gifts and other stock transactions. Review shareholder agreements to assess shareholder rights and to identify different classes of stock, such as preferred stock and nonvoting



shares. Beware of minority shareholders who might drag their feet and complicate a company's day-to-day operations.

Management. Before making a loan to a family business, make sure you're extremely confident about the company's management. Find out who really runs the show, because there may be an informal power structure. Some entrepreneurial business owners find it difficult to relinquish control. Organizational charts help, but in family businesses, titles may not reflect reality. Also, watch for family members who consider the company a free paycheck. If they don't care to contribute to the company, others may be in the same boat.

Related-party payments. Ask family business owners to prepare a schedule of payments made to family members for salaries, rent and other quasi-business expenses. Analyze salaries and rental agreements to ascertain whether they are reasonable or simply sweetheart deals. Exorbitant related-party payments will not only drain the company's cash, but also potentially demoralize unrelated employees, lower productivity and expose the company to unnecessary risks, such as an IRS audit. Some family business owners can't (or won't) separate business

funds from family funds. So don't risk an investment if owners balk at clearly listing how they plan to use loan proceeds.

Related-party loans. Some family business owners loan cash to younger family members. If this is the case, consider the creditworthiness of the related-party borrower. Could he or she have obtained traditional bank financing? Is he or she paying interest and making timely payments? Conversely, some companies issue notes payable when transitioning ownership to the next generation. These loans are particularly risky if the younger generation is unable to maintain the company's past level of financial performance. Regardless of the type of related-party loan you uncover, request that it be subordinated to any loan your bank has made.

Cast the Right Characters

Families come in all shapes and sizes and so do their businesses. While some family businesses operate like large corporations, many run as extensions of the family. That's not necessarily a bad thing — unless family problems creep into the workplace, jeopardizing operations and cash flow. Please call us; we can help unearth good family business prospects, or help you evaluate a current customer's solvency. 💰

Looking Into the Future

No one likes to think about disability or death. Family business owners are no different. The problem is they can be notoriously remiss when it comes to planning. That can be a grave mistake because failure to adequately plan for these events is the No. 1 reason family businesses fail. In fact, according to an article in the *Los Angeles Business Journal*, a shocking 70% of family businesses won't make it to the second generation, and only 15% will make it to the third generation.

Moreover, thanks to aging baby boomers, 39% of family businesses will likely change ownership over the next five years. Therefore, succession planning is vital. To avoid unpleasant surprises, inquire whether a family business owner has a succession plan that addresses the following fundamental questions:

What are his or her succession planning objectives? Some owners want to see their business passed on to their children. Others want to reward hard-working employees. Doubtless most want to minimize estate tax costs and ensure the family has enough cash to pay estate taxes. Succession plans should consider the sometimes conflicting needs of all company stakeholders, including siblings, children, distant relatives and even unrelated employees.

Is the next generation ready to carry the torch? Not all business owners' offspring are sterling successors who will look out for the continued health of the company. If the next generation appears ill-prepared to run the company, try to persuade the existing owners to hire a management team of qualified, outside professionals.

BEYOND THE NUMBERS

Recognizing the Warning Signs of Problem Customers

Improper Revenue Recognition

The Talk of the Town

Improper revenue recognition may not be a new problem, but it certainly has been hogging the limelight lately. After all, revenues drive executive compensation, company earnings and their valuation. When improprieties took center stage in recent corporate and accounting scandals, harsh reviews of company books ensued.

Today's headlines tout new, tougher securities legislation (the evolving Sarbanes-Oxley Act, for example) as American business's road to former glory. Certainly, the media feeds on these stories — company makes good, attains lofty heights, gets too big for its britches, is publicly humbled. Let's spotlight one financial-statement nook and cranny that answers your burning question: How do I separate a company's revenue fiction from fact?

The Overture

Revenue recognition is a stereotypical cad, outwardly handsome but inwardly corrupt. Motivated by a hangover of past and potential embarrassment, the SEC honed in on more than 227 enforcement investigations over a five-year period. The extent of the problem revealed itself when the SEC announced results from its corporate fraud survey, revealing the most common dastardly deed: improper revenue recognition, which accounted for more than half the cases.

Part of the overstatement dilemma stems from an economic shift toward service-oriented products such as software. Initially, software firms sold "products," meaning software programs. But their products expanded to include ongoing subscriptions, installation, training, technical

support, upgrades and enhancements — yet more places to create revenue.

Of course, publicly held companies aren't the only potential perpetrators. Private firms can also be managed by executives motivated to cook books for personal gain.

The Play Begins

When *should* revenue be recognized? The SEC answers in Staff Accounting Bulletin No. 101, which states "revenue should not be recognized until it is earned and realized or realizable." According to the commission, revenues are recognized when a company meets four criteria. The business must provide persuasive evidence of:

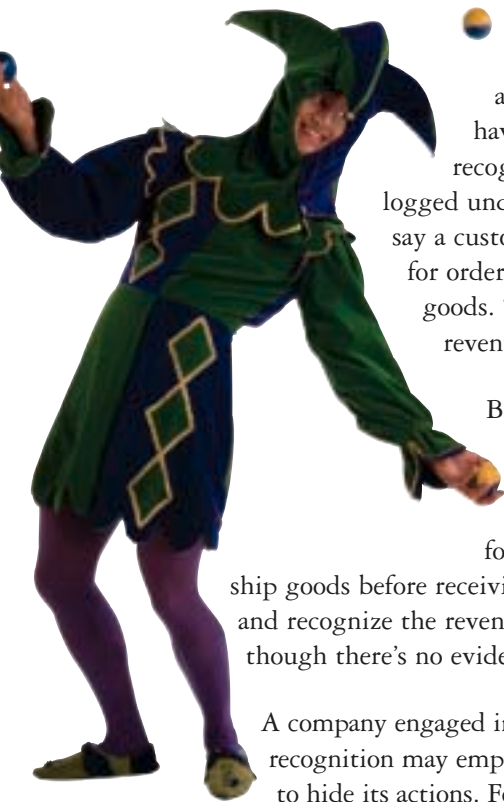
1. An existing arrangement,
2. Delivered product or rendered services,
3. A fixed or determinable seller's price to a buyer, and
4. Reasonably assured collectibility.

Sounds simple enough, but complexities abound. Even bulletin No. 101 acknowledges this by citing countless accounting guidelines addressing related and industry-specific issues.

Is It Friend or Foe?

Revenue recognition ploys range from basic timing mistakes to major acts of outright





fraud. For instance, a legitimate sale may have occurred but was recognized too soon (that is, logged under a prior date). Let's say a customer recognizes revenue for ordered, but not yet shipped, goods. That's premature revenue recognition.

But some companies are even more flagrant and enter fictitious revenue. They might, for instance, decide to ship goods before receiving an expected order and recognize the revenue immediately — even though there's no evidence they'll be paid.

A company engaged in fictitious revenue recognition may employ numerous scams to hide its actions. For instance, it may backdate invoices, change shipping dates or falsify records. Others have made shipments to company-controlled third-party warehouses or failed to record credit memos for returns. Side letters, rights of return, consignment sales, related-party revenue, and bill-and-hold transactions are all areas worth closer examination.

The Play's the Thing

How does your accountant detect premature or fictitious revenue? Several tools help them spot revenue problems. These guidelines determine whether the revenue-reporting pattern can be sustained:

Understand the revenue recognition policy. Companies should clearly state when and how they recognize revenues. Is it before delivery and performance? If so, is it truly earned? If a significant portion of the transaction remains open, such as installation or training, then part of the revenue should be deferred.

What about customer returns? The company should estimate returns and build them into its policy. The same holds true for price protections. If the company grants automatic refunds or credits for falling market prices, then it needs to make sufficient allowances and state this in its revenue recognition policy. Knowing the answers to these

and other questions helps businesses understand and detect questionable practices more quickly.

Watch accounts receivable. Unusual increases in accounts receivable often accompany questionable revenue recognition practices. This is because revenue that has been recognized, but not collected, needs to appear somewhere on the balance sheet. Because you won't find it under cash, accounts receivable becomes the most likely place.

For example, Sunbeam Corp. used a questionable bill-and-hold scheme, among other aggressive tactics, to boost revenue in 1997. In a bill-and-hold arrangement, revenue is recognized but collection is delayed. Accounts receivable would increase accordingly. In and of itself, this is not necessarily a problem. But it's a question of patterns. If accounts receivable increase faster than revenue for several quarters in a row, serious problems could emerge. A pattern of large and growing accounts receivable days signals an extended collection period that may be hard for a company to justify.

Consider physical capacity. Does the company have the physical capacity to generate the reported revenue amounts? While capacity is not always easy to measure, various methods examine ratios of revenue with respect to other factors such as the number of company employees; total assets; amount of retail or rental space; or type of property, plant and equipment.

Watch for unusual end-of-period transactions. A flurry of activity late in the reporting period, or a single significant last-minute transaction, may provide a red flag. Struggling to improve at least the appearance of financial health, management may be more inclined to engage in improper revenue recognition during these crucial reporting times.

The Final Curtain

Ethics and SEC regulations notwithstanding, fraudulent companies will always exist to play the antagonist. That's why having someone on your side — watching out for illegitimate reporting schemes and overly aggressive accounting practices — is so vital. We can help you unmask potential fraud before it directly affects you; so call us before improper revenue recognition raises its ugly specter. 💰



The Case of the Lawyer Who Asked for a Loan

two decades ago, most small to midsize law firms financed deals entirely through partners' equity. Not anymore. Now, bank-industry consolidations and a volatile economy have combined to make debt financing a much more adventurous undertaking. And lawyers' rising demand for loans can translate into lucrative opportunities for you.

Common Denominators

Today, law firms want their banks to provide escrow and investment accounts, pension administration, and payroll services. To cherry pick the best law firm prospects, look for these common denominators:

Professional goodwill. Law firms derive substantial value from intangible assets, a riskier source of collateral than their tangible counterparts. In turn, a firm's intangible value is inextricably linked with its partners. That is, when partners leave the firm, they take their professional goodwill with them.

To protect your loan portfolios, identify which partners generate the most revenue for the firm. Then, assess risk by considering the ages, health and future retirement plans of key revenue-generating partners.

Fraudulent income statements. You'd probably reject a law firm's loan request if its income statement showed no income for the year. That might be unwise, because a law firm's net income is largely unrelated to its true cash flow. Plus, as a tax planning strategy, many professional practices use partner draws to zero-out their profits at year end because law firms are usually flow-through entities (firm income is taxed on a personal, not a company, level).

For a more meaningful picture of a law firm's creditworthiness, look at revenue trends over the last five years. Avoid firms with erratic or declining revenues. Also consider cost efficiency; as a rule of thumb, small to midsize law firms

should achieve an operating margin (revenues minus overhead expenses, except attorneys' salaries, divided by revenues) of somewhere around 40%. Exercise caution if a law office produces a substantially lower margin.

Because most law firm operating expenses — such as rent, malpractice insurance and administrative salaries — are fixed over the short term, losing a key client can have a disproportionate effect on profits. For instance, forfeiting a client that represents 10% of the firm's revenues translates into a 25% reduction in profits, assuming a 40% operating margin.

You'd probably reject a law firm's loan request if its income statement showed no income for the year. That might be unwise, because a law firm's net income is largely unrelated to its true cash flow.

Hybrid accounting practices. It's difficult to benchmark a law firm's performance against its peers, because there is little accounting-method conformity within the legal profession. Some firms don't record any receivables, except those received from clients. For example, in a workers' compensation case, the attorney might pay the client's doctor bills to entice the physician to testify in court. If the client wins, he or she will pay the attorney with any proceeds; however, because attorneys often take these cases on contingency, the receivables are somewhat speculative.

Receivables are amounts invoiced but uncollected. And, invariably, attorneys have completed work for clients they haven't yet billed. So, unless the balance sheet shows a work-in-progress account, the firm's financial statements typically *understate* revenues and assets.

Special fee structures. Before financing a law firm's operations, find out how the firm generates its fees. Law firms can be broken into three types based on how they bill: traditional (flat or hourly) fee, contingency fee and combination firms. Those with many contingency fee cases are higher risk than traditional fee-based firms, because it's difficult to assess the potential financial hit of unsettled lawsuits.

Seek Co-Counsel

It's a law of nature that only the strong survive. An unwritten law of business could be: "Determine who the strongest are and do business only with them." Of course, there's no surefire way to always pick the winners; fortunately, there are ways to separate good risks from bad ones. If you need help assessing the financial health of a law firm prospect, give us a call. **\$**

Accrual Accounting Is No Joke

Generally accepted accounting principles and the Internal Revenue Code require most companies to use the accrual, rather than cash, method of accounting. This means the companies record revenues as they're earned and expenses as they're incurred. So, recording revenues and expenses is independent of cash receipts and payments. Analysis of accounts receivable, accounts payable and accrued expenses can help you detect financial trouble in advance. Here are some things to watch for:

Accounts receivable. The A/R account acts as a holding tank for earned — but yet unpaid — revenues. Among other problems, an out-of-control A/R account can signal bad debts or fictitious sales. Because receivables are relatively liquid, many companies pledge them as collateral. But beware receivable increases disproportionate to a company's revenue growth.

The A/R turnover ratio (calculated by dividing receivables by sales and multiplying the result by 360 days for annual financial statements) shows the relationship between receivables and sales. If the days in outstanding receivables increase from one period to the next, request additional information, such as an A/R "aging schedule," or hire a consultant to perform additional due diligence.

Accounts payable and accrued expenses. Similar to the A/R account, two liability accounts hold incurred but unpaid expenses: accounts payable and accrued expenses.

On one hand, extending the life of these current liabilities is smart business, because they are a form of interest-free financing. Conversely, delayed payments can anger suppliers and lead to higher costs as they charge you for the time value of their money. Eventually, they might require cash upfront or even refuse to do business.

To observe trends, your accountant will calculate the days outstanding in payables (by dividing payables by the cost of sales and multiplying the result by 360 days for annual financial statements). A significant increase in the days outstanding in A/P warrants further investigation. Also, keep a close eye on the balances of accrued expense accounts to ensure that these remain within reasonable limits.

If you suspect that one of your borrowers is playing an "accrual joke" on you, give us a call. We understand the issue's nuances and can help you uncover the warning signs of financial troubles before it's too late.

How Simone Macca & Larrow, LLP Can Help You...

- Loan investigation services
- Collateral monitoring
- Troubled loan reviews
- Pre-loan surveys
- Operational review
- Financial studies with operating ratios by industry

...and Your Customers

- Profit enhancement services
- Due diligence and consultation in merger & acquisition efforts
- Valuation for use in stockholders buy-sell agreements, sale of business and estate planning
- Business succession planning
- Employee stock ownership plans
- Accounting personnel searches
- Vendor negotiations
- Financing searches for non-bankable companies
- Management retreat facilitation
- Audit, accounting and tax services

**For more information, call
Carmen Macca or Richard Simone
Toll-free at 1-800-493-5605**



Carmen J. Macca, CPA, MST

Carmen is managing partner of Simone Macca & Larrow LLP and services a diverse commercial client base as well. He directs all lender services for the firm, including pre-loan surveys, collateral monitoring, operational reviews and lender seminars. Carmen assists lenders with borrowing-base reporting compliance and evaluation of customer management and accounting systems. Additionally, he assists companies in developing business plans, obtaining financing, preparing financial projections and with profit enhancement strategies. Carmen is a graduate of Bentley College and has a Master's Degree in taxation.



Richard C. Simone, CPA

Dick is partner-in-charge of Simone Macca & Larrow, LLP's Hamden office. He has over 30 years' experience in public accounting, with emphasis in real estate, construction, non-profit and medical practice. He handles individual, corporate and estate tax matters, and business consulting for closely-held companies. Dick served with the U.S. General Accounting Office in Washington, D.C. after graduating from Providence College.



Julianne J. Gillespie, CPA

Julie is the firm's audit partner with extensive experience in accounting, auditing, consulting and tax services within several industries, including manufacturing, real estate, architecture, engineering, insurance and printing. In addition, Julie has assisted her clients with financial reporting, cost control, systems, business planning, mergers and acquisitions, financing, cash flow analysis, and tax planning and projections. She assists with negotiating, structuring, monitoring and calculations of compliance ratios. Julie is a graduate of the University of Connecticut and has over 15 years experience as a CPA.

Simone Macca & Larrow^{LLP}

CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS ADVISORS

175 Capital Boulevard
Rocky Hill, CT 06067

PRSTD STD
U.S. POSTAGE
PAID
Permit No. 352
Rocky Hill, CT

ADDRESS SERVICE REQUESTED