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commercial lending report



Will Sarbanes-Oxley make the **CROOKED** go **STRAIGHT**?

Perils of **underfunded** pensions

death care lending — from beginning to end

Fraud Guidelines GOOD News for Lenders

Simione Macca & Larrow_{LLP}



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The Sarbanes-Oxley Act: Setting the Standards

Congress responded to last year's accounting scandals with the Sarbanes-Oxley Act.

Passed last summer, the act takes a hard stance against financial misstatement and corporate wrongdoers. But will its provisions make things more difficult for accountants and lenders? Let's look at what this still-evolving act tells us now and gauge where it may lead.

How Does It Work?

As we said, the act is a work-in-progress. But, here's an abridged version of Sarbanes-Oxley's salient points at the time this publication went to press:

Establishes a Public Company Accounting Oversight Board (PCAOB). Regulated by the SEC, the five-member PCAOB has a wide range of full-time responsibilities, including registering public accounting firms, adopting auditing and other financial reporting standards, conducting investigations and disciplinary hearings, and enforcing compliance with the act. The PCAOB is scheduled to debut in late April 2003.

Requires audit firms to register with the SEC. A firm's registration is subject to PCAOB approval before October 2003. Registered firms will also pay an annual fee to fund the board's operations.

Describes consulting services that audit firms may not provide for their audit clients. Congress has concluded that numerous nonaudit services can impair an auditor's independence. Among the act's list of prohibited activities are bookkeeping, design and implementation of financial and information systems, actuarial services, valuations, fairness opinions, internal auditing, management or human resource functions, broker and dealer services, investment banking, legal services, and expert witness services.

Mandates partner (but not firm) rotation. Although the act does not call for audit firm rotation, the firm must designate different partners to serve as "audit partner" and "review partner" for each of its clients every five years.

Changes the auditor-client relationship. Under the act, the audit committee must now appoint, compensate and oversee the audit firm. Because auditors will report directly to the audit committee, the audit results won't be subject to management machinations. The act also requires that at least one audit committee member be a financial expert. (The SEC determines financial expertise based on education and experience, so financial experts would normally include CFOs, controllers and CPAs.)

The act requires public companies to provide additional disclosures for off-balance-sheet transactions, pro forma financial information, special-purpose entities, the code of ethics and internal controls.

Holds CEOs and CFOs accountable for their companies' financial reports. Top executives must sign certifications guaranteeing "to the best of their knowledge" the financial statements' reliability. The act also calls for stiffer penalties for and equitable relief from corporate wrongdoers. In addition, the act forbids staff members such as officers and directors from trading during pension fund blackout periods and prohibits loans to the company's top executives. The only exception is if the business operates as a consumer credit company, and the loans are "done in the ordinary course of business on the same terms and conditions made to the general public."

Improves the information provided by financial statements.

The act requires public companies to provide additional disclosures for off-balance-sheet transactions, pro forma financial information, special-purpose entities, the code of ethics and internal controls. In addition, many financial reports must be made in a timely manner. For instance, if a company officer sells stock, the transaction must be recorded within two days of the sale.

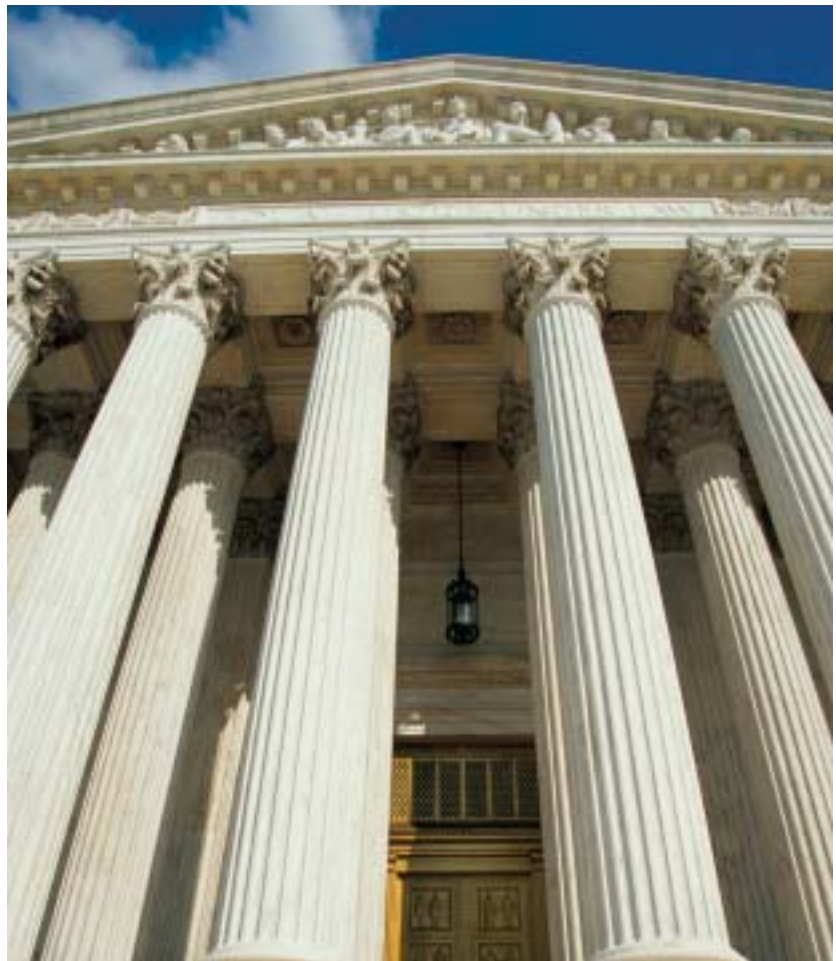
What Does It Mean to You?

Sarbanes-Oxley is good news to corporate lenders, because it attempts to improve financial-statement reliability and accuracy, as well as to stiffen the penalties for white-collar crime.

You'll also have more time to file a lawsuit if a customer falsifies financial statements. That's because the act extends the statute of limitations on fraud to the earlier of five years from when the fraud was committed (previously three years), or two years after the fraud's discovery (previously one year).

Although you might not lend to public companies, or even require audits from your customers, Sarbanes-Oxley's implications are still pertinent. Right now, the decision whether to extend Sarbanes-Oxley to small and midsize private companies is in the states' hands. While we can't predict the future, it's likely many states will follow the federal government's lead and extend many elements of this legislation to smaller companies.

Doing its part, even the American Institute of Certified Public Accountants (AICPA) is proposing revised auditing standards. (See "Fraud Guidelines Good News for Lenders" on page 7). Although the PCAOB may allow the AICPA to retain its rule-making authority, the board can amend, modify, repeal or reject any accounting standard. The AICPA is expected to seek financial reporting



reform. Because the AICPA makes the rules for companies that follow generally accepted accounting principles, it's likely that private, unaudited companies will face many of the same requirements (and punishments) as their publicly traded counterparts.

The audit firm must designate different partners to serve as "audit partner" and "review partner" for each of its clients every five years.

Where to From Here?

The Sarbanes-Oxley Act is the mostly positive counterpoint to last year's scandals. How much it will ultimately transform the way we do business remains to be seen. Rest assured the next several months will bring changes, one hopes all for the better. For additional information and the latest news about Sarbanes-Oxley, visit the SEC's Web site at www.sec.gov or the AICPA's Web site at www.aicpa.org. You can also call us to discuss this act or any accounting issue you face. **\$**

Perils of Underfunded Pensions

glare from the late 1990's stock market boom blinded investors and business-people alike. They were dazzled by high-flying numbers whose end was nowhere in sight. When the myth of perpetual good times ended, broken companies and defaulted loans littered the landscape.

Survivors pick up the pieces, try to figure out where they went wrong and what precautions they should take. For lenders, that means rigorous due diligence. Underfunded pensions are one of the more unglamorous — but potentially devastating — signs of a company in peril.

Flying Too Close to the Sun

Pension fund assets are primarily invested in the stock market. During the go-go years, much of the assets were in equities. According to a 2002 Morgan Stanley study, pension funds flew parallel with the stock market, from a \$292 billion surplus (reflecting a 30% surplus to their commitments by year end 1999) to an estimated \$150 billion deficit by year end 2002. While the market was defying gravity, so were pension assets; that allowed some

companies to report overfunded pension assets and pension investment gains as earnings.

The IRS and Employee Retirement Insurance Security Act (ERISA) demand, via complex pension laws, that companies rectify this deficit. So, businesses must dramatically increase pension-plan contributions, which will seriously affect their cash flow, earnings and financial performance, as we'll soon see.

Pension Basics

Most companies offer employees either a defined contribution plan or a defined benefit plan, both of which the IRS and ERISA extensively regulate. Under a defined contribution plan, such as a 401(k), the vested amounts credited to each covered employee determine each employee's benefits.

In contrast, in the defined benefit pension plan, a complex formula specific to each plan determines participants' benefits. In other words, if a company has a defined benefit plan, it must contribute amounts sufficient (on an actuarial basis) to cover the benefit liabilities and the



plan's administrative costs as they become due. Seven out of 10 S&P 500 firms have chosen defined benefit plans.

The law imposes minimum funding standards on pension plans whose value is determined using the portfolio assets' projected rate of return. If those standards aren't met, the plan sponsor is subject to an annual tax (10% of that year's accumulated deficit). Further, steeper taxes can be imposed if the pension sponsor fails to correct the accumulated deficiency.

Short of mass firing or dire pension reductions, a company can reduce its pension shortfall in two ways. It must either contribute more money to the plan (a cash outlay made in the current period) or earn higher rates of return on its investments — certainly a less “controllable” option than the first.

Perhaps the only way companies can comply with ERISA minimum funding standards is to write checks from current cash flows directly to their pension plans. The startling magnitude of some companies' payments portends danger:

- General Motors (America's largest pension plan) had a pension shortfall of \$22.2 billion at the end of last year's third quarter. That's equivalent to more than 80% of its market capitalization. GM has announced plans to put \$9 billion into its plans by 2007.
- Delta Airlines' shortfall was \$3.5 billion, equivalent to 150% of its market value.
- United Technologies must contribute more than \$1 billion in 2003 to cover its shortfall.
- Delphi Corp. will contribute \$1 billion in 2003; that amount still may not cover its shortfall.

Source: UBS Warburg study quoted in Time magazine in 2002 estimating pension shortfalls and required contributions for the largest pension plans.

Following the Law

As part of your due diligence, make sure loan applicants' pension plans abide by IRS and ERISA requirements. Helpful actions include:

- Review the pension plan's financial assumptions in detail, including underlying assumptions about expected returns,
- Establish each pension plan's employee obligations,
- Confirm that plan documents are filed, the plan is exempt from income tax and it properly reports its liabilities,
- Review all of the plan's amendments and summary plan descriptions,
- Assess the plan sponsor's employment and collective-bargaining agreements, personnel policies, and other documents describing employee retirement benefits, and
- Review each pension plan's reports filed with the IRS to determine underfunded, as well as fully vested, liabilities.

Remember, this is just a partial list. For the most thorough due diligence possible, please give us a call.

Contributions funneled to underfunded pension plans mean that cash cannot be used for capital expenditures, market expansion or paying down debt. For lenders and investors, the combination of complex accounting and greater uncertainty equals trouble. Plus, plan obligations and their required contributions vary by participant and aren't reflected in financial statements, though they must be calculated in accordance with ERISA.

Using a Flight Plan

Financial Accounting Standards Board (FASB) Chairman Robert Herz referred to pension accounting as “complex” and “somewhat opaque” (*Chicago Tribune*, Nov. 28, 2002). If the FASB chairman finds pension accounting challenging, imagine how you — with myriad other tasks to tackle — will find it. So, free your time and protect your interests by collaborating with an expert familiar with pension accounting's intricacies as well as its ERISA and tax implications. Please call us to help unearth pension landmines and steer you toward less financially volatile customers. 💰



Is Lending to Death Care Providers a Grave Mistake?

While no business is completely fool- or recession-proof, the death care industry reaps the rewards of continual demand. In fact, 22,000 funeral homes generate more than \$10 billion in annual revenues, according to *Fortune* magazine. But before you lend to these potentially lucrative clients, consider the following particulars.

The Ghost of Business Past

The 1990s were generally kind to death care providers' coffers. Four publicly traded companies — Service Corp., Stewart Enterprises, Loewen Group and Carriage Services — even went on a buying spree. They introduced economies of scale by having nearby funeral home “clusters” share an embalming facility and vehicle fleet. Then, in classic cart-before-the-horse logic, they leveraged the deals with “cheap” debt financing, anticipating earnings high enough to repay heavy debt loads.

The bottom fell out of the funeral home market in January 1999, leaving many investors and bankers in dire straits.

At the acquisition frenzy's peak, public funeral homes provided investors with healthy 30% annual returns. Unfortunately, the bottom fell out of the funeral home market in January 1999, leaving many investors and bankers in dire straits.

The Ghost of Business Present

Today, funeral giants' stocks are selling for a fraction of their one-time highs. Loewen Group, for instance, filed for bankruptcy, while others scramble to dig out from under monstrous debts. According to morningstar.com and bigcharts.com, Service Corp.'s balance sheet shows \$8.8 billion in long-term debt — nearly 4 times its annual revenues and 8 times its market capitalization.

Sales are down because consumers can purchase discounted caskets, grave markers and other death services online. In addition, Americans are increasingly choosing cremation, a cheaper (but higher margin) alternative to traditional burial. And, thanks to medical advances and healthier lifestyles, baby boomers are hardier than actuarial tables anticipated.

The Ghost of Business Future

Fortunately for the industry, the Census Bureau predicts the current 2.4 million-person annual death rate will rise to 2.6 million by 2010. So, though the industry leaders' unexpected demise burnt many lenders, small- and middle-market funeral homes are still worth exploring. What should you do? Look for established



funeral homes that want to borrow money for traditional reasons, such as inventory needs, fixed-asset acquisitions and remodeling. Be suspicious of prospects trying to fund aggressive telemarketing campaigns or rapid expansion into new geographic markets.

Lending Happily Ever After

So, before you take on a death-care-industry client, interview the funeral director to see whether he or she is up-to-date on regulatory changes, market trends and consumer needs. In addition to reviewing the prospect's financial statements, ask how

the director sets prices so you can see whether the business employs sound practices. Also, look for fraudulent financial-reporting schemes. Some dishonest directors, for example, will boost revenues by immediately recording 100% of the revenues earned from multiyear installment contracts.

Certainly, lending to the death care industry has its pitfalls. But don't let them keep you from considering a loan to a funeral home or other entity. If you need assistance assessing a funeral home or other prospect's financial health, please call us. We can help you circumvent lethal repercussions. **\$**

Fraud Guidelines Good News for Lenders

A recent survey by the Institute of Management Accountants revealed a startling statistic — 87% of managers will commit fraud to make their companies look better. That statistic probably gives lenders the chills. Luckily, the AICPA has issued a new Statement on Auditing Standards (SAS) that should improve auditors' chances of uncovering fraud. The new standard, which will be finalized this summer, will apply to all companies — public or private — that prepare audited financial statements.

In response to the Sarbanes-Oxley Act and the accounting profession's tarnished reputation, the Auditing Standards Board proposed a new statement, *Consideration of Fraud in a Financial Statement Audit*. Although auditors still don't have a responsibility to detect fraud, the proposed SAS expands the definition of fraud and guides accountants in designing their audit procedures to spot fraud risks and uncover material misstatements.

These revised guidelines (1) stress that fraud should be a concern throughout the audit, (2) require expanded management inquiry, (3) call for customized audit procedures aimed at identifying and targeting high-risk areas, and (4) require that auditors communicate evidence of suspected fraud and any high-risk areas to the appropriate managers.

Unfortunately, the proposed SAS doesn't require that auditors communicate fraud or its high-risk areas to bankers, because it would compromise the accountant's confidentiality obligations. Nonetheless, improved fraud detection standards are good news to anyone whose livelihood depends on financial statements' accuracy and reliability.

For more information about the still-evolving Sarbanes-Oxley Act, see "The Sarbanes-Oxley Act: Setting the Standards" on page 2.

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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.



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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.

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