

November/December 2003

# commercial lending report

Keeping asset-based loans  
out of **HOT** water

Customer expense reports  
**REVEAL MUCH**

Should you associate with  
association-managed communities?

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# Keeping asset-based loans out of **hot** water

**T**hanks to today's widespread liquidity shortages and enticing interest rates, many companies are looking for asset-based loans. Opportunistic managers hope to take advantage of record-low interest rates by borrowing to purchase new capital equipment or expand into different markets. Others just need additional funds to weather temporary decreases in demand or slow customer receipts.

On the surface, all of that seems like good news for lenders. But in reality, it's a tough time to be a commercial lender. In 2002, U.S. banks lost nearly \$37 billion from commercial loan defaults — more than the combined net income of the four largest banks in the United States.

With only 24 hours in each day, today's lender faces a tough choice: Should I focus on marketing to new customers or on conducting due diligence on the companies already in my loan portfolio? Despite deep-seated pressure to increase the size of their portfolios, lenders simply can't afford to take short cuts on due diligence in light of the recent upsurge in loan defaults.

## Will customers stay afloat?

Under any circumstances — let alone today's — it behooves lenders to continually evaluate prospective borrowers and monitor customers' creditworthiness. Here are several steps you can take to protect loan portfolios:

**Avoid shortcuts.** Be selective when making new loans or extending an existing customer's credit. Don't be tempted to take shortcuts on a new customer's due diligence, because it's much easier to deny a loan request than it is to subsequently rid yourself of a "problem child." So, diligently analyze a prospective borrower's financial performance.

When it comes to existing customers, it may be tempting to accept the status quo. In fact, with so many conflicting obligations vying for limited time, many lenders adopt an "if it ain't broken, don't fix it" attitude. This may well lead to unnecessary losses. To mitigate risk, periodically

review existing customers' performance as you would a new customer's. In addition, periodically re-evaluate your customers' rankings, which can quickly change in today's dynamic marketplace.

To be fair, the downturn has been hard on most companies, so don't be shocked if a new customer's financial ratios indicate a downward trend, or an existing customer's performance slides. Slight deterioration could be an offshoot of the sluggish economy and doesn't automatically mean you should refuse credit.

If it appears a new or existing customer's performance can't possibly improve — even once the economy recovers — then it's cause for concern. Also, be wary of businesses that have had trouble obtaining financing; their frustrated managers may become desperate enough to bend numbers to secure cash.



Due diligence takes time, and many of the skills it requires are beyond a lender's professional expertise. Most lenders rank their customers according to their relative risk and spend a disproportionate amount of time monitoring their "problem children." Although this time management strategy is often effective, it's usually not enough. You may need to call on an outside accountant to perform in-depth due diligence.

**Look beyond the numbers.** Although due diligence efforts are often focused on quantitative

results, you shouldn't lose sight of qualitative factors, such as management's personalities, employee morale, and the company's reputation. In addition, consider how economic changes impact the company's industry.

Furthermore, don't solely rely on management's representations or company-produced documents. As part of its due diligence procedures, your bank's field auditors or an external CPA can examine third-party-prepared documents, including bank statements, and vendor invoices. You can also design procedures to confirm individual account balances by phoning or writing to a sampling of the company's customers.

Another important part of due diligence is visiting your customers' premises — not just when originally securing a loan but throughout your relationship. Look for unused equipment and obsolete or dusty inventory. Perform random inventory counts and reconcile your test counts with the company's inventory schedule. Remember, too, that employees often know when something's awry, so ask to interview key personnel.

## Smooth sailing with customized covenants

With limited time and numerous ready-made lending software programs at their fingertips, lenders may be tempted to use loan agreement templates without considering the need to add or modify the borrower's covenants.

The need to customize a customer's loan covenants is commensurate with its perceived risk. If, for example, you rank customers using a traditional grading system, an "A-" customer's covenants won't require much tweaking, but a "C-" customer will likely warrant preventive measures.

If you have the foresight to incorporate items (such as limited shareholder loans, restricted use of loan proceeds, and interim financial statements or audits) into the borrower's covenants, it speeds future due diligence. It can also help you identify and rid yourself of problem children before it's too late.



While site visits are usually scheduled, don't discount surprise visits. They prevent unscrupulous managers from having a chance to cover their trails, destroy documents or move inventory.

**Watch how the company uses cash.** The statement of cash flows is arguably the most under-rated financial statement. However, it can provide you with valuable insight into a customer's performance. By reviewing a customer's cash flow statement, you will uncover how the company is using your loan proceeds.

For instance, you'll find that some business owners can't differentiate between company funds and their own. These misguided owners think they're entitled to special privileges, including excessive or unrecorded loans and even misappropriated assets. While most shareholder defalcations are difficult to unearth, a large personal investment — coupled with insufficient operating cash flow — is a recipe for financial disaster.

## Shore up your resources

In these turbulent times, you don't have to go it alone. In fact, you may be unfamiliar with the latest fraud detection techniques. Delegating the analysis of high-risk customers to a financial expert can allow you time to focus on expanding your portfolio. In addition, a third-party tends to be more objective, which may enable him or her to uncover things you've overlooked. Please call us to help evaluate a current customer's financial situation or to analyze a prospective borrower's numbers. 💰



INTERNAL CONTROLS

# Beyond the Numbers

RECOGNIZING THE WARNING SIGNS OF PROBLEM CUSTOMERS

## Customer expense reports reveal much

**E**mployees have exaggerated or fabricated expenses since the dawn of commerce. And, as long as reports have documented expenditures, dishonest personnel have submitted padded expense statements. That may not sound dire, but false expense reports can quickly add up to serious consequences for an employer — and, tangentially, for its commercial lender.

Employers stand to bleed money if they don't rein in expense reimbursement fraud. To worsen matters, after successfully bilking their companies, novice fraudsters often graduate to bigger and bolder scams. Moreover, other employees quickly catch on and join in. It's difficult to defend against any crime, especially those committed by perpetrators who often perceive ill-gotten gains as overdue compensation.

Because lenders often must act as gatekeepers for their customers, it's important that you learn to recognize the signposts that dot the road to a customer's potential financial problems. Lenders should also remind their banks' field auditors to keep their eyes open for phony expense reports — not only can they be a precursor to larger scams down the road, but they can also provide the auditors with a warning sign that the customer has a weak, ineffective internal control system.

### The case of the felonious tech expert

Sometimes one person has too much responsibility. Bill was solely responsible for procuring, installing and maintaining his law firm's technology. In addition, he handled the attorneys' security, telephone and videoconferencing systems.

Because the firm's partners recused themselves of anything technology-related, they trusted Bill implicitly. So, he was never questioned about — and was seldom denied — his recommendations. For its part, firm management was exceptionally remiss in administrative chores, such as inventorying its fixed assets or maintaining effective internal controls.

After three years, Bill had saved enough to buy a new house. On moving day, he chuckled to himself as he surveyed the “house-warming gifts” his employer had unwittingly purchased for him. For instance, the company had generously contributed to his down payment, a new stereo system, a DVD player and a home security system to prevent robbery. It's amazing what fudged expense reports can buy.

Although these so-called “gifts” amused Bill, they were truly no laughing matter. He illegally had acquired all over a three-year period — first through fictitious reimbursements and later through outright theft.

### The case of the crafty CFO

Meanwhile, Martha, a manufacturer's CFO, has been padding her expense checks for years. She began her fraud spree as a salesperson exaggerating travel expenses and passing off family dinners as business meals. When she transferred to the accounting department, Martha realized the extent of the company's lax expense reimbursement policy, as well as the prevalence of her co-workers' expense reimbursement abuse.

## Bringing offenders to justice

Because expense reimbursements sometimes require subjective estimates, and because some employees do make honest mistakes, you can't expect customers to adopt a zero-tolerance policy. Nevertheless, punishment should be more than a mere reprimand.

The company should investigate all inconsistencies in the employee's past expense reports to estimate the fraud's magnitude. The employee should be swiftly, and commensurately, punished.

As she was entrusted with greater responsibility, Martha's exaggerations grew into felonies. Compounding matters, no one signed her expense reports, which became a personal piggy bank. Eventually, Martha graduated from skimming cash to six-figure pension fund misappropriation.

But this time the manufacturer lucked out. Eventually, the company's loan officer noticed some irregularities in the year end financials and sent a team of field auditors to the customer's headquarters. Before uncovering Martha's pension-fund follies, the auditor noticed her exaggerated expense reports, which led the team to evaluate the effectiveness of the customer's internal control system and, eventually, to uncover Martha's larger defalcations. As a result, Martha probably traded pinstripes for prison garb, and the manufacturer likely was rescued from default.

### Doing detective work

Many corporate lenders refrain from inquiring about expense reimbursements. Some think it's meddlesome, beyond their scope of responsibility, or out of their hands.

Others underestimate the importance of this seemingly minor offense.

Because falsified expense reports are often a precursor to more audacious swindles and can provide clues to a customer's weak internal controls, don't ignore this issue. If you're unsure exactly how to broach the subject, try asking

your customers some of these questions about their expense reimbursement policies:

### How detailed is the company's expense report?

An expense report format should never be at an employee's discretion. The company's standard form should require details about out-of-pocket expenses, including the cost, date, purpose, attendees (for meals) and distance (for mileage). For larger expenses (say, anything more than \$25), personnel should provide receipts. Additionally, if a cost ties to a specific job, employees should note that on the form so the cost can be passed on to the customer.

### Does the controller examine all expense reports?

A company's accounting department is its first line of defense against expense report fraud. The controller should question large or unusual items and compare expense report requests to other documents, such as the business's fixed-asset listing or the employee's time. To control employee spending, some controllers provide a per diem meal allowance for traveling employees and require a purchase order before employees can buy large articles.

**Do expense reports require a manager's signature?** It never hurts to have a second set of eyes review employees' expense reports, and supervisors often know their subordinates better than the company's controller does. In addition, this extra step helps prevent collusion between an employee and the controller.

**Does the company maintain a detailed inventory of its fixed assets?** Rather than purchase fixed assets on a casual, as-needed basis — like the fictitious law firm discussed previously — companies should closely track their major assets. A detailed fixed-asset inventory exceeds brief descriptions and costs. It also lists serial numbers, purchase dates, purchasers, asset locations, and, if applicable, parties accountable for lost or stolen items.

**How often does the company require employees to submit expense reports?** Most employees want to receive expense reimbursement quickly to recoup out-of-pocket costs. Others, however, put off this tedious task and submit several months' reports at once. This tends to overwhelm the accounting department, compromising its thoroughness. Moreover, unless expense reports are timely, it's difficult to pass the costs on to customers.

Ask your bank's field auditors to evaluate the suspect customer's internal controls, including its expense reimbursement policies. Too often, lenders, auditors and other stakeholders take the strength of a company's internal controls for granted, as we saw previously in the case of the crafty CFO.

### A lesson learned

These fictitious case studies share at least one commonality: Both perpetrators kicked off their crime sprees by falsifying their expense reports. Through these initial experiments, Bill and Martha knew their employers' lax policies and internal controls offered them fraud opportunities. They should have asked the questions discussed in "Doing detective work"

on page 5. But Bill and Martha's inaction afterward is as bad as not having asked them at all.

Had their early attempts been unsuccessful, they might not have moved on to bolder swindles. What's more, if caught and punished, Bill and Martha might have served as examples, deterring co-workers from a corrupt path.

Even minor schemes can portend impending financial disaster, the worst-case scenario being customer bankruptcy. In addition to using your bank's field auditors to uncover falsified reports, we can help you comb customers' expense reimbursement policies and with other accounting matters. 💰

## Should you associate with association-managed communities?

**R**oughly 50 million Americans live in association-managed communities, including cooperatives and residences governed by homeowners' or condominium associations. Despite the growing popularity of such associations — more than 80% of housing starts over the past five years have opted for community association oversight — lenders often shy away from these nontraditional borrowers. Can you bank on an entity whose primary asset is its future income stream?

### Collateral issues

When a community's common areas need repairs and the cash to make them, the association's board seeks a loan. But, unlike most borrowers, associations can't guarantee the money's return, because they don't technically own anything, except perhaps an operating account, a replacement reserve account or — for those with collection troubles — some (overdue) fees receivable.

Though these entities initially may lack appeal, don't rule them out without considering the upside. While they don't offer much substantive collateral, community associations typically will pay above-average interest rates (usually 1% to 2% above prime), as well as 1% to 1.5% commitment fees.

Furthermore, as long as a community follows its declarations and bylaws, it contractually secures its association income stream. Plus, most boards can place a lien (collectible when the unit sells) on any property if the owner doesn't pay his or her annual association fee.

### 3 steps to due diligence

Before lending to an association-managed community, perform adequate due diligence:

- 1. Do your homework.** Ask the board to provide several key documents, including its declarations, bylaws and any amendments. Review board meeting minutes, paying particular attention to those taken when the board approved fee increases. Your risk rises if the increase was narrowly approved or substantially resisted, because "nuisance" owners may refuse to pay or possibly seek legal action.
- 2. Take a field trip.** Visit the property and research its history, demographics and nearby real estate market conditions. Loans to community associations are less risky, for example, if:
  - Owner turnover is low,
  - Owners rarely default on fee obligations,

- Property values are increasing, and
- Owner occupancy is high.

3. **Conduct interviews.** Get to know the association's board. A professional board stays on top of needed repairs; provides structural, mechanical and electrical engineering reports for its proposed project; and constructs pro forma cash flow statements for the loan's term.

## Still not sure?

If their growing popularity and surprisingly low-risk cash flow aren't enough to pique your interest in these associations, also consider that lending to them demonstrates your community commitment. Please call us to discuss concerns about lending to these unique entities or to review the creditworthiness of a particular loan prospect. 💰

## All aboard the SBAExpress

A recession brings out bankers' selective and cautious natures. This is especially true when customers are smaller — and, therefore, riskier — ventures. Nevertheless, during this economic downturn, small-business loans are rapidly increasing, according to a recent American Bankers Association report.

To mitigate small-company risk, many banks are turning to Small Business Administration (SBA) loans, which the federal government guarantees. One reason for rising numbers of small business loans has been the SBA's introduction of a special, multifaceted version named *SBAExpress*:

**SBAExpress vs. traditional SBA loans.** This revamped program offers numerous benefits over traditional SBA offerings. For instance, *SBAExpress* allows you to use your own loan-approval forms and scoring procedures, whereas

traditional SBA loans require a stringent, time-consuming, SBA-designed approval process, which turns off many lenders.

### **Raised SBAExpress borrowing ceiling.**

*SBAExpress* has received a face-lift since its 1995 unveiling. For example, the maximum borrowing ceiling has risen from \$150,000 to \$250,000 (to coincide with the typical small business loan cutoff amount), and the workout/liquidation processes have been streamlined to save time and money.

There is, however, one *SBAExpress* downside. While the SBA guarantees 75% to 85% of traditional SBA loans, it guarantees only 50% of *SBAExpress* loans.

Although riskier than larger customers, small businesses can be a profitable niche for lenders. In fact, the SBA allows lenders to charge a 6.5% premium over prime for loans up to \$50,000 and 4.5% over prime for larger loans.



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### **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.

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