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Discretionary change or financial misstatement?

Recent accounting standard can set off false alarms

When a borrower restates financials, it can be a red flag for fraud or other suspicious behavior. But while restatement may conjure images of aggressive accounting estimates, backdated stock options and other questionable accounting practices, it doesn't always signal impropriety.

Financial Accounting Standards Board (FASB) Statement No. 154, *Accounting Changes and Error Corrections*, now requires companies to retrospectively report prior periods for voluntary changes in accounting principles. The new rule also demands more extensive disclosure for changes and error corrections.



Out with the old

Previously, Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, governed accounting changes and corrections of errors. Under these rules, errors, such as mathematical mistakes or misapplications of generally accepted accounting principles (GAAP), triggered restatement of financial results and required detailed disclosures.

Reporting for accounting changes was less straightforward, however. Accounting changes fell into three broad categories:

1. **Accounting principle.** Companies may change from one GAAP principle to another, either

voluntarily or under FASB mandate. For example, it may be “preferable” for a company to switch from LIFO to FIFO inventory valuation methods.

APB 20 typically required companies to report the cumulative effect of most changes in accounting principle as an adjustment to net income. Additionally, comparative statements didn't require restatement of prior years.

2. **Accounting estimate.** Some financial statement items, such as allowances for bad debts, warranty expense or useful lives of long-lived assets, rely on management's judgment. As new information becomes available, estimates may change.

APB 20 required companies to report changes in accounting estimates prospectively in the current or future periods affected by the change. Prospective reporting required no prior period adjustments or pro forma disclosures.

3. **Reporting entity.** Related companies may decide to combine, separate or reallocate the way they report their financial results. For example, a group of subsidiaries may decide to combine their results into one consolidated statement rather than prepare several individual financial reports. Under APB 20, changes in reporting entity required companies to retroactively restate financial results.

In with the new

FASB 154 replaces APB 20 and FASB 3. In some ways, it's business as usual. The new rule retains most of the reporting requirements for changes in accounting estimate and reporting entity. One noteworthy exception, however, is that changes in depreciation, amortization or depletion method now fall under the change in accounting estimate (rather than the change in accounting principle) umbrella.

Reporting requirements for changes in accounting principle have changed significantly. The new statement specifically differentiates error corrections from changes in accounting principle, although both events require similar adjustments. Error

corrections — which have earned a negative connotation — officially call for *restatement*. Conversely, voluntary or FASB-mandated accounting principle changes require *retrospective application*, unless they are impractical.

FASB defines retrospective reporting as “the application of a different accounting principle to prior accounting periods as if that principle had always been used.” It includes only direct effects of accounting changes, net of any related income taxes.

Retrospective application requires companies to quantify period-specific effects of accounting principle changes and adjust retained earnings rather than lump the cumulative effect together on the income statement. Companies also must adjust the carrying amounts of assets and liabilities as of the beginning of the first period presented.

Sarbanes-Oxley and the private company

Large public companies spend millions of dollars annually on Sarbanes-Oxley Act (SOX) compliance — generally viewing compliance costs as little more than a regulatory nuisance. Small public companies, however, often have insufficient resources and financial sophistication to implement SOX.

In fact, the seven-figure price tag associated with SOX compliance has many small public companies considering delisting or relisting in foreign countries. Moreover, looming SOX costs are deterring some large private companies from accessing the public markets.

It’s easy to understand, therefore, why private companies may be reluctant to adopt SOX rules voluntarily. Nevertheless, to keep your borrowers in line, you may want to recommend or require that they follow some Sarbanes-Oxley provisions.

Minimize costs, maximize rewards

You can encourage your borrowers to consider SOX rules by highlighting some of the more cost-effective provisions of the law:

The new rule further calls for expanded disclosure regarding the justification for accounting principle changes, methods for applying the change, indirect effects and impracticability exceptions.

Coming soon

Although FASB encourages early adoption, Statement 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after Dec. 15, 2005. In other words, retrospective reporting for changes will hit calendar-year entities’ 2006 financial statements.

To differentiate benign accounting principle changes from suspicious restatements, you must dig beneath the surface. Read footnote disclosures carefully, discuss statements with borrowers and ask accounting experts to help you understand the underlying cause of any restatement. **\$**



Audit committees. SOX requires public companies to create an independent audit committee that includes at least one financial expert qualified to interpret external audit reports and ask relevant technical questions.

Companies must provide adequate funding to compensate audit committee members for additional efforts and to pay for independent legal and financial advice. But these funding requirements are minimal compared with the compliance costs associated with other SOX provisions, such as the much-maligned Section 404 internal control implementation, assurance and documentation mandates. To assure auditor allegiance to the audit committee — rather than to company management — companies must permit their audit committees to meet with external auditors without management.

Prohibited services. Section 201 of SOX prohibits auditors from providing certain consulting services — such as bookkeeping, appraisals, fairness opinions and internal audits — for their public audit clients. The law also requires audit committee approval for other nonaudit services that exceed 5% of external audit fees.

Nonaudit services falling in this “gray area” include transfer pricing studies, tax-only valuations, and tax compliance and planning. This provision prevents companies from relying too heavily on one CPA firm for financial expertise. Additionally, consulting fees for nonaudit services not only generate higher profit margins but also tend to dwarf audit fees. Simply by using separate firms for their consulting and audit needs, your borrowers minimize potential conflicts of interest and maximize your confidence in their financial reports.

Management accountability. Under SOX’s Section 302, top executives must sign off on public company financial statements. This provision goes beyond the standard audit representation letter, requiring management to pay attention to financial statement contents, including disclosures. It also holds executives formally accountable for misrepresentations.

Other worthwhile SOX-inspired ideas for private companies include implementing a formal code of ethics, a whistleblower hotline and internal audit functions. Each of these practices specifically targets fraud — giving investors and lenders greater confidence in financial controls.

Who benefits?

Some private companies will benefit more from SOX provisions than others. Companies planning to go public, for example, may want to tackle compliance early to avoid post-IPO costs and delays. And those contemplating a merger or acquisition with a public company are more likely to sell for a premium if they’re SOX-compliant.

Voluntary and mandatory SOX adoption is also common among nonprofits these days. The Nonprofit Integrity Act of 2004, for example, requires California NPOs to prepare audited financial statements and create an audit committee that approves contracts for nonaudit services.

Smart business

Some SOX provisions are cost prohibitive for private companies, but many are just smart business. Virtually every company could benefit from stronger internal controls and fraud prevention policies. Lenders who help their customers adopt a practical cost-benefit approach to SOX compliance are likely to reap substantial benefits. 💰

Z scores help screen for potential credit risks

When businesses go broke, lenders lose. So wouldn’t it be helpful if you could predict bankruptcy before it strikes?

Z scores can offer a quick and effective way to distinguish healthy borrowers from those teetering on the brink of collapse.

Brief history

In the late 1960s, Dr. Edward Altman of New York University’s Graduate School of Business studied financial ratios to determine which were the most reliable predictors of bankruptcy. He compared a sample of 33 bankrupt manufacturing companies to a random sample of 33 healthy manufacturers with asset sizes ranging from \$1 million to \$25 million.



Altman computed 22 ratios for each company and identified five with the highest correlation to bankruptcy:

A = working capital / total assets

B = retained earnings / total assets

C = earnings before interest and taxes (EBIT) / total assets

D = market value of equity / book value of total liabilities

E = sales / total assets

Using statistical analysis, Altman computed a correlation coefficient for each ratio to use in a weighted average equation. This, in turn, generated a metric dubbed the Z score. Generally, the higher a company’s Z score, the better its financial performance. Low Z scores warrant further investigation. Altman also provided specific cutoff guidelines to quickly determine whether a company is healthy, distressed or somewhere in between. (See “Z score coefficients and cutoffs” on page 5.)

Z score coefficients and cutoffs

	Public manufacturer	Private manufacturer	Private nonmanufacturer
Ratio	Coefficient	Coefficient	Coefficient
A = working capital / total assets	1.200	0.717	6.560
B = retained earnings / total assets	1.400	0.847	3.260
C = EBIT / total assets	3.300	3.107	6.720
D = market value of equity* / book value of total liabilities	0.600	0.420*	1.050
E = sales / total assets	1.000	0.998	N/A
Bankruptcy risk	Cutoff	Cutoff	Cutoff
Low if score greater than	2.99	2.90	2.60
High if score less than	1.81	1.23	1.10

* Because private stock prices are not readily available, the Z score models permit private companies to substitute the book value of equity.

Altman recently revisited his study to determine whether Z scores continue to gauge financial health reliably. His findings — including updated correlation coefficients and cutoffs — were published in a 2006 book, *Corporate Financial Distress and Bankruptcy*, 3rd edition.

Scores for every borrower

Realizing that there are significant differences between public and private entities, as well as between manufacturers and other types of businesses, Altman offers three versions of the Z score model. There is one for public manufacturers, another for private manufacturers and a third for private nonmanufacturing businesses.

In addition to using modified correlation coefficients and cutoffs, private companies may substitute the book value of equity in Ratio D. Because asset turnover ratios vary significantly among retailers and service providers, the general-purpose Z score model eliminates the industry-sensitive Ratio E.

Theory in practice

Here's how the Z score works for a hypothetical private manufacturer. Given the data in the table above, the equation for computing the Z score would be:

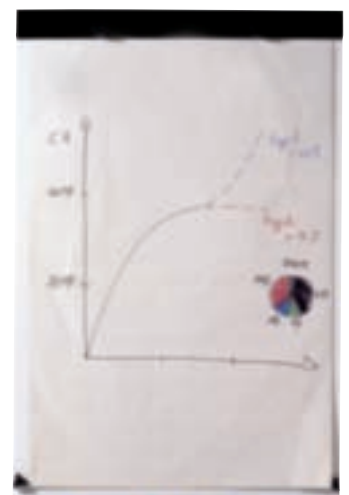
$$Z = (0.717 \times A) + (0.847 \times B) + (3.107 \times C) + (0.420 \times D) + (0.998 \times E)$$

For simplicity, assume ratios A, B and C equal 0.15. Ratios D and E equal 0.3 and 2.4, respectively. Plugging these numbers into the Z score equation produces a Z score of 3.22. Based on these inputs, the company appears healthy. Its Z score is above the 2.90 bankruptcy cutoff Altman provides.

Z score limits

Unfortunately, no statistical tool is 100% accurate. In Altman's study of 120 distressed firms from 1997 to 1999, the original Z score model correctly classified 84% of bankrupt firms as distressed within one year of failure. The model misjudged approximately 25% of nonbankrupt firms as distressed, however.

Z scores are subject to several limitations. For example, the average company in Altman's updated study had approximately \$100 million in total assets, so very small



firms and large public conglomerates may not be comparable.

The original Z score model correctly classified 84% of bankrupt firms as distressed within one year of failure.

Moreover, when private companies substitute the book value of equity for the market value (Ratio D), it assumes that historic costing reasonably approximates market values of assets and liabilities. In many cases, balance sheets significantly undervalue equity, which calls into

question this ratio's viability as a default predictor for private firms.

One tool among many

Z scores provide no guarantees and should never be the sole method used to evaluate a borrower's financial health. The method does, however, offer a systematic approach to evaluating credit risk by measuring how closely a borrower resembles other firms that previously have filed for bankruptcy.

If Z scores aren't already part of your lending arsenal, consider them. Low Z scores can give you an excuse to arrange face-to-face meetings with problematic customers and brainstorm possible improvement strategies. 💰

It's official: Fair value is here to stay

The Financial Accounting Standards Board (FASB) issued Statement No. 157, *Fair Value Measurements*, last September — more than two years after it released the statement's controversial exposure draft.

FASB 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." So when estimating fair value, companies should consider only those assumptions common to market participants that can exploit the asset to its "highest and best use." Fair value specifically excludes entity-specific considerations, such as transaction costs and buyer-specific synergies.

FASB 157 recognizes three approaches to valuing assets: the cost, income and market approaches. FASB ranks these methods according to their fair value hierarchy — favoring identical or comparable market prices (as used in the market approach) over unobservable inputs (the basis for discounted cash flow and income capitalization methods).

A mixed bag

To date, approximately 40 accounting standards reference the term "fair value." Although this new rule doesn't mandate any new fair value measurements, it does clarify terminology and provide guidance for measuring fair value. It also underscores FASB's ongoing commitment to fair value reporting over historic costing.

Fair value, however, is a mixed bag. In theory, it promises to improve financial statement relevance, transparency and consistency. In practice, it requires borrowers to report lower profits.

Fair value requirements generally are unpopular among accounting professionals and business owners — particularly those who own small businesses lacking in-house valuation expertise and resources to hire outside appraisers.

The bottom line

What does this mean for lenders? As borrowers implement standards mandating fair value reporting, financial statements may change. In some instances, these changes may set off false alarms or violate loan covenants. Some borrowers may switch to non-GAAP financial statements to avoid the cost and confusion associated with fair value measurements.





Beyond the Numbers

Dealing with distressed borrowers

The relationship between lender and borrower is much like a marriage. Everything goes smoothly during the honeymoon, but the partnership may be sorely tested during financially tumultuous times. When your customers fail to meet expectations, will you stick it out or jump ship?

When failure breeds success

Lenders considering divorcing themselves from a faltering customer might consider the hypothetical E&F Machine Shop — a company that encountered several stumbling blocks on the road to success.

Before informal reorganization in June 1999, E&F's shortcomings were numerous. Roughly 85% of its revenues came from a manufacturer that unexpectedly filed for bankruptcy at the end of 1998. Owner Mac responded by aggressively discounting jobs to attract new business and compete with larger shops.

Personal matters added to business woes. Mac's business partner and close friend, Bob, was in the midst of a bitter divorce and dating the shop's controller, which was causing morale issues among employees. Finally, Mac hired his son, a recent business school graduate with no machine shop experience, to improve shop floor efficiency.

When the bank called to discuss E&F's financial turmoil, Mac was honest, open-minded and somewhat relieved. The lender put him in touch with outside experts who helped identify problems — including the perils of working with friends and relatives — and find solutions.

Mac decided to hire an experienced shop manager and bought out his business partner. He also stopped discounting and focused on finding new customers that were willing to pay a premium for small batches, quick turnaround and specialized tooling. Mac also diversified the shop's customer base so that no individual customer represented more than 10% of revenues.

Within two years of reorganization, E&F's revenues had doubled, its cash account exceeded \$250,000 and profit margins were the highest in the shop's history. Now Mac is contemplating building a new facility to house his flourishing business — with the unfaltering support of his steadfast lender.

Intelligent failures

Some failures are worth hanging on to. But not all. What makes this hypothetical tool shop unique is management's ability to learn from the past.

When evaluating whether to throw in the towel, assess how owners and top managers perceive failure. In many organizations, failure is taboo. Management tries to hide it or, worse, punishes employees for trying new ideas. Such closed-mindedness stifles innovation and leads to repeat blunders.

Effective managers should espouse the mantra, "Nothing ventured, nothing gained." It's also imperative that management continually gauge performance to catch failure early, when it's less expensive to fix.

Building relationships that work

Like marriage, enduring lending relationships require hard work. This means taking time to acquaint yourself with prospective borrowers — through site visits, management interviews and financial statement review — before committing funds to them.

Once the honeymoon is over, continue to monitor performance. And, when a borrower encounters bumps, communicate your concerns but honor your commitment by helping it work through problems. Your objectivity and resources will strengthen your bond and build long-term customer loyalty. **\$**

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