

COMMERCIAL LENDING REPORT



OCTOBER/NOVEMBER 2011

What drives value, drives credit

In good form

Getting borrowers to think outside the corporate box

**Financial statement
footnotes are more than a P.S.**

Your borrowers' hidden liabilities

PDI GLOBAL NICHE MARKETING NEWSLETTERS HELP BUILD YOUR SUCCESS

See the last page and visit our website to learn why PDI Global newsletters — available in electronic and print formats — should be part of your marketing and client communication program.



THOMSON REUTERS™

800 227 0498 www.pdiglobal.com

*Brand this area with **your** logo and contact information!*

WHAT DRIVES VALUE, DRIVES CREDIT

Balance sheets give financial statement readers insight into a company's financial position — its assets and liabilities — at a given point in time. But don't be tempted to equate the book value of equity on the balance sheet with the equity's fair market value. For many reasons, these values can be significantly different.

START WITH THE BALANCE SHEET

The balance sheet is a logical starting place for lenders conducting due diligence — and for appraisers applying the cost approach to value a business. But it's important to recognize how book value differs from market value.

Intangible assets — brand names, patents, customer lists, goodwill and so on — are usually omitted from the balance sheet, unless acquired from a third party. Contingent liabilities (see “Back to basics” on page 7) also may be excluded.

Additionally, assets are reported at the lower of cost or market value. So, a building acquired 50 years ago may be worth far more than the balance sheet reflects.



Accelerated depreciation methods also tend to underestimate the value of property, plant and equipment. For example, a fully depreciated tool, which has no value on the balance sheet, may continue to be used in daily operations. Accounts receivable may include stale, uncollectible invoices, especially if the borrower isn't audited.

Balance sheet adjustments, future earnings, industry trends and comparable transactions are important parts of the valuation equation.

Also, keep in mind that most companies like to write off assets after they've been fully depreciated for book or tax purposes. So, in many cases, an asset may exist but the books don't reflect it.

Financial statement analysis can provide insight when, as a lender, you're critically evaluating the balance sheet. If accounts receivable or inventory is growing faster than revenues, for instance, it may suggest inefficient collections or purchasing.

The statement of cash flows, if you can obtain it, also can be telling. Say that you look at cash flows from investing activities. Is management reinvesting in future operations through regular capital investment? If not, the borrower's fixed assets might be run down or obsolete.

TRACK FUTURE EARNINGS

Under the market and income approaches to valuing a business, your borrower's value is a function of its future earnings. Many factors inside and outside the company may alter future expectations.

A new competitor, changing consumer tastes or emerging technology, for example, could render a borrower obsolete in a few years. Pay attention to period-to-period trends revealed on comparative income statements. If you require audited or reviewed financial statements, you often can add comparative financials to the engagement without significantly affecting your customer's bottom line.

Then dig deeper. Research industry trends. Ask borrowers to provide benchmarking data from a professional or trade association to which they belong. Also request copies of your borrowers' annual and five-year business plans. These sources might provide insight into future earnings, more so than historic performance.

EVALUATE COMPS

When appraisers use the market approach to value a business, they rely on the sales of comparable businesses. Likewise, lenders should watch for the sales of local comparables. Although details of private business deals aren't publicly reported, business appraisers have access to private transaction databases. This data reveals the selling price and terms of deals in your borrower's industry, which is particularly helpful when lenders finance mergers and acquisitions.

Also understand the composition of the industry: How does your borrower measure up to competitors? What makes your borrower stand out in the industry? Directly asking these questions is the easiest way to get the answer, and it will help determine whether the borrower is a good lending opportunity.

KEEP YOUR EYE ON VALUE

A borrower may hire an appraiser to value the business in a shareholder dispute, in a divorce or



for tax purposes. Always ask for a copy of formal appraisals. Write-ups about business operations, industry analysis and financial trends can be informative. And it's noteworthy to compare net book value with the valuator's final conclusion. Pinpointing the sources of discrepancies between these two values provides greater insight into what's driving value and what's missing on the financial statements.

Also keep your eyes and ears open for informal value indicators. The owners might, for instance, receive an offer to purchase the business, estimate business value on a personal loan application or draft a buy-sell agreement.

THINK LIKE AN APPRAISER

Balance sheet adjustments, future earnings, industry trends and comparable transactions are important parts of the valuation equation — and lenders can use them to predict creditworthiness. By thinking more like an appraiser, you'll get more from your borrowers' financial statements. This, in turn, will lead to more informed lending decisions. \$

IN GOOD FORM

Getting borrowers to think outside the corporate box

Many borrowers operate as C corporations to limit their personal liability. But sometimes the costs (such as double taxation) and hassles of incorporation outweigh the benefits. Hybrid options, however, offer the best of both worlds: limited personal liability *and* tax savings.

Entity choice requires careful consideration. Have your borrowers weighed all the options and made the optimal choice?

SOLE PROPRIETORSHIPS

As the name implies, proprietorships are owned by one person who holds all business assets, assumes sole responsibility for business debts (including exposing personal assets to business risk), makes every business decision, and reports business profits (or losses) on his or her personal tax return. Proprietorships face few formalities, other than obtaining necessary operating licenses. They also dissolve when the owner dies or otherwise terminates the business.

If the administrative and tax costs of incorporation outweigh the potential liability risks, sole proprietorships may be a better choice. In fact, proprietorships represent about 72% of U.S. businesses, according to the Census Bureau's *Statistical Abstract of the United States: 2011*.

GENERAL PARTNERSHIPS

When two or more owners decide to go into business together, a partnership is their simplest option. Partnerships usually are governed by a written partnership agreement that addresses such issues as duration, capital contributions, distributions and transfers.

Unlike corporations, partnerships don't pay federal income tax. Instead, a partnership's profits and losses, capital gains and losses, tax credits, and other tax items flow through directly to the partners'



personal income tax returns. Partners then pay the tax, irrespective of whether they've received cash distributions from the business.

All partners in a *general* partnership are jointly and severally liable for business obligations. This means that, if a partnership defaults on a \$100,000 loan, your bank can sue all the partners jointly — or one partner (or any combination of partners) — for the entire balance. Any partner sued for more than his or her pro rata share of the liability then can seek compensation from the remaining partner(s).

Assessing partners' personal financial condition — both jointly and individually — is relevant when lending to partnerships. Sometimes it makes sense to seek restitution from the partner with the deepest pockets.

LIMITED PARTNERSHIPS

Limited partnerships blend the flow-through tax benefits of a partnership with the limited liability benefits of a corporation. This organizational

structure is a popular way for small business owners to raise private capital but retain control.

As are partners in a traditional partnership, *general* partners in a limited partnership are jointly and severally liable for partnership obligations. But the liability of limited partners is *limited* to the amount of their investment in the partnership.

The catch is that limited partners can't be actively involved in the partnership's daily operations. However, acting as a guarantor on a loan doesn't constitute active participation in management. So, don't be afraid to ask limited partners to guarantee your loans.

Also, a limited partnership must file limited partnership certificates wherever it does business. If it doesn't, limited partners may become general partners and thus liable.

HYBRID OPTIONS

When owners want to maintain control and managerial flexibility but also limit their personal liability and entity-level tax, they often turn to hybrid ownership structures. Examples include limited

liability companies (LLCs), limited liability partnerships (LLPs) and S corporations.

As do corporate shareholders, hybrid entity owners generally enjoy protection of their personal assets from the business's creditors. But no structure completely limits owners' liability. Banks can "pierce the corporate (or LLC or LLP) veil" and sue shareholders personally if the entity is misused through fraud or other illegal activity. Lenders also can hedge their bets with personal guarantees from corporate and hybrid borrowers.

The rules, limitations and requirements governing these hybrid structures vary from state to state. Before choosing one of these options, borrowers should seek professional advice.

EFFECTS ON LENDERS

Lenders have a stake in their borrowers' choice of organizational structure. This decision affects not only your bank's methods of legal recourse and exposure to liability risks, but also the face of your borrowers' financial statements. When comparing types of entities, lenders must understand the differences to avoid inaccurate comparisons. \$

DOES A SEPARATE LEGAL ENTITY MAKE SENSE?

Operating a fleet of separate legal entities can result in a tangled web of financial reporting. But sometimes it's beneficial to set up separate legal entities. Carving out real estate into a separate legal entity, for example, can protect an operating business from property claims (or vice versa).

And separate legal entities will limit the borrower's liability. Many restaurant chains, for example, incorporate each location separately in the event of a liability claim, because the claim would be effective against only the one location.

Separating noncore business segments also can allow owners to cherry-pick the segments they wish to participate in. When a homebuilding firm contemplated segueing into the rental market, for instance, it created a separate legal entity for the rental venture. Some shareholders abstained from participating in the new entity but continued to participate in homebuilding. This setup sidestepped a potential shareholder dispute.

Separate entities also are useful in estate planning. A business owner can contribute private stock to a newly formed family limited partnership and retain control through a general partner interest in the partnership. Then he or she can gift limited partner units to any children at a substantial discount from the stock's market value for lack of control and marketability.



FINANCIAL STATEMENT FOOTNOTES ARE MORE THAN A P.S.

The review of your borrowers' financial statements is a critical tool in evaluating risks. But it's the footnotes that may be most helpful in revealing underlying details — and potential problems.

To get the most out of your financial statement review, it's important not only to read the footnotes carefully, but also to read between the lines.

WHEN RELATED PARTIES EXIST

Companies may give preferential treatment to, or receive it from, related parties. Footnotes should disclose all related parties with whom the company — and its management team — conducts business. Then lenders should critically evaluate related-party transactions to determine whether they're at "arm's length" — and whether significant risk factors exist.

For example, the president of fictitious company Bulldozers, Backhoes and Beyond is a silent partner in one of its customers, a struggling homebuilder. This potential conflict of interest might be mentioned nonchalantly in a footnote. But what probably wouldn't be disclosed is the preferential treatment the related party receives.

WHEN THE ACCOUNTING CHANGES

Companies should disclose in the footnotes the nature and justification for a change in accounting

principle or method, as well as the change's effect on their financial statements.

Lenders should check that the stated reasons are valid, such as a regulatory mandate. Dishonest managers can use accounting changes in, for instance, depreciation or inventory reporting methods to manipulate financial results.

WHEN EVENTS ARE SIGNIFICANT

Footnotes also should disclose significant events that could materially impact future earnings or impair business value, such as the loss of a major customer or stricter regulatory oversight next year.

But fraudsters may overlook or downplay significant events to preserve the company's credit standing. Savvy lenders stay atop industry trends and meet regularly with borrowers to avoid being blindsided by emerging trends or changes in the business environment. Also monitor changes in financial ratios over time and request interim financial reports to catch undisclosed events early.

WHEN LIABILITIES ARE CONTINGENT

Footnotes should reveal certain contingent liabilities, such as a potentially damaging lawsuit, an IRS inquiry or an environmental claim. But unscrupulous borrowers may downplay these liabilities to avoid violating loan agreements or admitting financial problems to stakeholders.

For more on contingent liabilities and how to uncover them, see "Back to Basics" on page 7.

READ THE SMALL PRINT

Risks affect the value of your borrowers' business and their ability to repay loans. Always pay close attention to the small print in their financial statements. Footnotes can offer the clues to financial stability that figures might not. \$



YOUR BORROWERS' HIDDEN LIABILITIES

It's every lender's nightmare: A borrower gets blindsided by an unexpected liability that renders it insolvent, irreparably tarnishes its reputation or impairs its ability to repay debts. Not every potential liability is reported on the balance sheet, so how can you protect your loans from such risks? Here are some *hidden* liabilities you can uncover if you look carefully.

CONTINGENT LIABILITIES

Some future obligations — the outcome of a pending lawsuit, an IRS inquiry or a regulatory investigation, for instance — may be missing from a borrower's balance sheet. Certain contingent liabilities appear on the balance sheet only when they're reasonably estimable and are more than likely to be incurred.

Footnotes, when available, disclose the nature and extent of the contingent liabilities. The likelihood of loss will be described as "probable," "reasonably possible" or "remote." The ability to estimate a loss is described as "known," "reasonably estimable" or "not reasonably estimable." (Also see "Financial statement footnotes are more than a P.S." on page 6.)

UNDERFUNDED PENSIONS

As baby boomers retire and live longer than past generations, a borrower's pension fund assumption may turn out to be overly optimistic, causing it to have to pay out more to retirees than its balance sheet reflects. The result: Your borrower's pension kitty may be insufficient to cover future obligations.

If a borrower offers pension benefits, ask about the assumed long-term rate of return on investments and the discount rate used to compute net present value. The lower the rates, the more conservative the borrower's assumptions and the less likely the plan is to be underfunded.

INDUSTRY AND INTERNAL RISKS

Some hidden liabilities are a function of the borrower's industry. Manufacturers and contractors, for example, typically warranty work and must adhere to applicable union and safety regulations.



Borrowers also face internal risks. Examples include reliance on key people or concentration risks if one customer (or supplier) represents more than 10% of revenues (or cost of sales). The loss of a key person, customer or supplier can significantly compromise future

earnings. Lenders can keep tabs on industry and internal risk factors by interviewing company personnel, brainstorming with external audit staff, and joining industry trade associations.

YOUR ATTENTION REQUIRED

Private firms pose a greater risk when it comes to hidden liabilities. Not only are their financial statements less likely to be audited by a CPA — and, therefore, less likely to disclose contingent and other hidden liabilities — but they also tend to possess fewer resources to weather losses. Professional skepticism and regular visits to your borrowers' facilities are your first line of defense against these risks. \$

POWERFUL MARKETING AND CLIENT COMMUNICATION TOOLS

Communicating regularly with clients, prospects and referral sources is key to building top-of-mind brand awareness, positioning your firm as a thought leader and developing stronger client relationships. That's exactly what our niche marketing newsletters — available in email, online and print formats — are designed to do.

Newsletters from PDI Global, part of Thomson Reuters, give you the look, content and format you want — without the hassle of producing one yourself. Our economies of scale allow us to offer high quality newsletters for appreciably less than it would take to do something comparable yourself. And our newsletters always go out — even when your firm is too busy to write one.

Plus they feature professionally written content reviewed by experts for technical accuracy, as well as eye-catching designs you can brand with your logo and customize with a personal message or other information. (See “Make this newsletter your very own” at right.)

A VALUE-ADDED COMMUNICATION SOLUTION

When you subscribe to one of our newsletters, you don't just get an image-enhancing publication. You get a value-added communication program that includes:

- Access to an online library of articles you can publish under your byline in local media, email to clients, post on your website, use as handouts or include in other mailings
- Free *Tax Law Change Updates* you can email to clients and contacts or print for handouts
- Best practice tips and ongoing marketing assistance from our account representatives

Also, because our private-label newsletter programs are licensed on an exclusive basis in specific market areas, you don't have to worry about competitors sending the same newsletter to your contacts.

PUT THEM TO WORK FOR YOUR FIRM

To learn more about these outstanding publications, visit www.pdiglobal.com. If you don't see a newsletter there that meets your needs, let us know. We'd be glad to create a custom one that does.

For availability, pricing and ordering, call us at 800-227-0498 or email information@pdiglobal.com — and start turning more of your firm's potential into profit.

Make this newsletter your very own

Customize this entire back page with any copy and images you like; for example:

- An article you write or download from our online Content Store
- Information about your firm and the services you provide
- Biographies and photos of key partners
- Testimonials, client profiles and success stories
- An ad, special offer or invitation to a firm event

