Trust earned.
FreedMaxick™
ABL SERVICES, LLC

How asset-based lenders can reduce the risk of lending

Executive Summary

We are pleased to present a collection of best practices, focused on how to best reduce the risk of lending that we've seen from great companies making thoughtful, analytical decisions about potential borrowers.

OUR KEY FINDINGS INCLUDE:

- The best lenders understand the strengths, weaknesses, opportunities and threats (also known as "SWOT") of their clients and prospects. The analysis can also play a critical role in due diligence, in addition to assisting borrowers identify opportunities to make improvements or better respond to external threats.
- As a lender, you can add value and protect yourself from financial distress by introducing your borrowers to a benchmarking process comparing their performance against industry norms or best practices
- Analyzing how a customer's liquidity metrics change over time or how liquidity ratios compare to certain industry benchmarks may indicate an inefficient deployment of capital if you encounter huge increases in liquidity — or even ratios that are well above industry norms.
- Some borrowers will exaggerate their receivables in order to get a loan. A savvy banker, however, will know what to look for on the receivables end so that they don't get duped in the process. If you go the extra mile with due diligence – digging deeper o evaluate risks - it's more likely that your estimation of customers' loan worthiness will be spot on.
- As a lender, you've likely developed close ties with your family business clients but when you take the time to get to know family members, it's possible you'll unearth certain business practices that can jeopardize debt service. This is true especially when the business transitions to second generation ownership.
- Just as fire requires fuel, oxygen, and heat, occupational fraud requires motive, opportunity and rationalization. These are what forensic accountants call the "fraud triangle." And economic downturns, such as the one we're currently in, can ignite fraud by fueling all three factors.
- When you meet with borrowers or tour their facilities, make sure you look for circumstances that are ripe for misstatement or theft. Creative journal entries to avoid defaulting on a loan or an inflated sales record in order to preserve bonuses (jobs), are two conditions that deserve particular scrutiny

Trust earned.™

Table of Contents

FreedMaxick™
ABL SERVICES, LLC

Introduction

How do you know when there is risk in lending?

In a constantly changing economy, lenders are more likely to be wary of certain borrowers than they may have been in the past. Borrowers need to have to not only show a lender that the risk of loss is low, they are going to have to prove that the risk of lending is worth taking.

Nowadays, lenders need to ask several questions when evaluating borrowers:

- What is your business? What does your business do?
- What debts do you currently have, and what is the status on them?
- What are your monthly itemized expenses and their amounts?
- Does your business have any collateral?
- Can you explain any items of note on your credit report?
- If you are currently in debt, how did you accrue it and what steps will you take to stop incurring more debt?
- How much money are you looking to borrow in this loan?
- How do you plan on repaying this loan?

Asset-based lenders need to take steps to evaluate potential borrowers and reduce the risks of lending in order to achieve a successful relationship between lender and borrower. In this whitepaper, we take a look at several ways to take caution when evaluating risks and protect the lender's assets and collateral. Asset-based lenders should consider various forms of analysis and approach each borrower individually to determine if there is risk in lending and if so, how to best reduce that risk.

How Asset-Based Lenders Can Use SWOT Analysis to Evaluate Potential Borrowers

SWOT ANALYSIS LOOKS AT BORROWERS' STRENGTHS AND WEAKNESSES

Author: Paul R. P. Valera, CPA, MBA, Senior Field Examiner

The best lenders understand the strengths, weaknesses, opportunities and threats (also known as "SWOT") of their clients and prospects. The analysis can also play a critical role in due diligence, in addition to assisting borrowers identify opportunities to make improvements or better respond to external threats.

Here's how a client's SWOT analysis can asset-based lenders make better lending decisions.

Unearthing the source of each strength

A SWOT analysis begins with identifying strengths and weaknesses from your customers' perspective. Strengths typically represent potential areas for building value and boosting revenues. These may be competitive advantages or core competencies. Examples might include a loyal customer base, a strong brand image, or an established customer list.

It's critical to unearth the source of each strength. Some are tied to the company's owners or key employees, such as an older partner with influential standing in the business community and an impressive client list. This is especially common among professional practices, such as accounting, advertising or law firms. But retailers and manufacturers may rely on key people, too.

When strengths are tied to people, rather than the business itself, you need to consider what might happen if a key person were to suddenly leave the business. Ask whether the borrower has non-complete contracts, key person life insurance, a buy-sell agreement, or a formal succession plan to transition management to the next generation.

Weaknesses represent potential risks and should be eliminated or minimized. Often they are evaluated in relation to the company's competitors. Weaknesses might include weak internal controls, high employee turnover, unreliable quality or a location with poor accessibility.

Of course, all businesses have an Achilles' heel. But when a borrower reports the same weaknesses every year, it's cause for concern. It's not enough to simply recognize a weakness — the borrower needs to take corrective action.

For example, one borrower decided to boost its weak sales force with a headhunter to acquire new talent, Dale Carnegie sales training classes to inspire the staff, and a new-and-improved commission structure. Within just a few months, the business's year-to-date sales were up 35%. And the borrower now lists its sales force as a strength, not a weakness.

Looking outside

The second part of a SWOT analysis looks externally not only at what's happening in the industry, but also with the economy and regulatory environment. An opportunity could be favorable external conditions that might increase revenues and value if the company acts on them quickly.

For example, a pharmaceutical company responded to emerging health care legislation and the aging baby boomer demographics by purchasing smaller medical device and generic drug manufacturers. Both the acquirer and its targets have acted on favorable external opportunities with a roll-up to improve their financial positions.

As you can imagine, threats are unfavorable conditions that can prevent an unwary borrower from achieving certain goals. Threats arise from the economy, competition, technological changes and increased regulation. It's critical to watch for and minimize any existing and potential threats.

Hospitals and doctors, for example, are keeping a close eye on health care reform legislation, because it threatens to lower their billing and collection rates from private and public sources. Many physicians are banding together to improve bargaining power and achieve economies of scale.

How about your customers?

If your customers haven't completed an in-house SWOT analysis, it's time to do it. SWOT is a proven management tool that's been taught at business schools around the world. Strong borrowers will say "yes!" immediately and discuss the results. But you may need to encourage your weaker, less experienced borrowers to tackle the analysis. The end result, however, will enlighten them.

A SWOT analysis is typically presented as a matrix (see the chart), and provides a logical framework for understanding how a business operates. It can not only tell what a borrower is doing right (and wrong), but it can predict how outside forces can impact cash flow in a positive (or negative) manner.

SWOT MATRIX

	Positive	Negative
Internal	Strengths	Weaknesses
External	Opportunities	Threats

Business owners love their work and typically don't want to hear that their businesses aren't operating at peak performance. So, if you have concerns about a risky borrower, suggest they do a SWOT analysis. It can be an objective forum for discussing sensitive or negative issues.

Don't put it off

As you know, due diligence can be a daunting task. And no single approach works for every customer. But a well-executed SWOT analysis can provide a method to the madness.

Example of SWOT in action

Mr. Moneybags is a loan officer with four auto dealerships in his portfolio. However, Mr. "M" was concerned when his dealerships reported their 2011 results. Sales and profits were down, and credit lines were up. In addition, inventory wasn't turning. So, Moneybags asked the dealer-owners to a "state-of-the-industry" meeting. Before the event, each dealer was asked to brainstorm not only what he or she perceived to be opportunities and threats in the industry, but what their internal strengths and weaknesses would be.

The result was a lively show-and-tell, with every dealer collaborating and sharing best practices. Everyone, including Mr. Moneybags, left the meeting with ideas and information. Although the industry is starting to show signs of improvement, Moneybags and his dealers still plan to continue their SWOT discussions in 2013 and beyond.

Why Banks Should Use Benchmarking to Analyze Potential Borrowers

INTRODUCE BENCHMARKING TO ADD VALUE AND PROTECT CLIENTS FROM FINANCIAL DISTRESS

Author: Paul Muldoon, CPA, CIA, CFE, Senior Manager

A great analytical tool that all banks should employ is "benchmarking," which compares a company's performance against industry norms or best practices. Some owners, however, skip this exercise, often because they become bogged down with daily operations or they're simply unfamiliar with benchmarking resources.

As a lender, you can add value and protect yourself from financial distress by introducing your borrowers to the benchmarking process.

A CASE STUDY

When Jane Anderson switched banks to consolidate her company's debt and lower its interest rates, she received an unexpected, but delightful bonus — financial insight — from an unexpected source: her new banker.

As part of its normal due diligence protocol, her new bank benchmarks every borrower's financial statements against Risk Management Association industry norms. And, if a borrower doesn't measure up, the owner receives a friendly follow-up call.

When the banker phoned Jane, he pointed out that her company's days-in-receivables was some 15 days longer than the industry average and its days-in-inventory was almost double the norm.

Jane became defensive, saying, "You need to spend some time in the real world! Our collections have been around 65 days for decades. Our customers simply won't pay faster!"

The banker responded kindly by pointing out that her portfolio included other borrowers in the same industry, and of roughly the same size, that matched the benchmarks. Although Jane's performance didn't violate any loan covenants, he recommended that she consult a CPA to get her company's asset management back on track.

Thanks to the banker's insight, Jane's average collection period is now down to 54 days. She's also taking training courses on inventory management software to help her assess safety stock (which is simply a level of extra stock maintained to mitigate risk of stockouts) and reorder points. And she's been able to free up cash to spend on some new equipment as well as pay shareholders an unexpected dividend.

Look at the entire picture

Of course, changes in a borrower's performance over time are only part of the story. Just because a company has survived for 30 years with a 65 days-in-receivable ratio doesn't always mean it's healthy. After all, a collection period of 65 days is totally unacceptable if competitors collect in 50 days.

Lenders and owners must gauge how others in the industry are doing in terms of growth, asset management, profitability and debt coverage. Major expenses that are worthy of comparison are rent and management compensation, especially if paid to related parties.

No universal benchmarks will apply to all types of businesses. So it is critical to seek data that's sorted by industry, size and geographic location. Also, encourage borrowers to share any data they get from trade journals, local roundtable meetings or conventions.

As you've likely gathered, benchmarking data has certain limits, and comparisons may be imperfect. But it will always provide some insight, no matter how small a niche your borrower's operations may be.

Ratios are also a moving target

Ratios also tend to change over time. If more competitors enter the marketplace, for example, collections may slow and margins will narrow. Why? Because the more suppliers there are in an industry, the less control those suppliers will have over their customers.

There are other factors that can affect ratios: regulations, technology and economic conditions. So be sure to employ current benchmarking data to avoid setting unreasonable goals. You must also realize that benchmarking is a continuous process, not a one-time event.

We're here for you

If during a preliminary benchmarking you find any weaknesses, make sure you refer the business to a CPA for more detailed insight. He or she can help tutor the borrower, as well as implement change and bring grades up to par.

Borrower's Liquidity is a Crucial Concern for Asset-Based Lenders

WHY MOUNTING RESERVES MAY NOT BE GOOD FOR LENDERS

Author: Paul Muldoon, CPA, CIA, CFE Senior Manager

As the recession plods along, it's likely that borrowers might take a rather conservative approach to liquidity. In fact, according to the 2012 AICPA Business and Industry Economic Outlook Survey, more than a third of CFOs are stashing away more operating cash flow in their bank accounts than ever before. And some don't even have plans to deploy their cash reserves.

While rainy day funds might be reassuring to lenders, excessive kitties could be a very inefficient use of capital that borrowers may regret down the road. What's needed? A scientific approach to estimating reasonable cash reserves. With such an approach, borrowers can reinvest surplus cash in higher yield alternatives that may improve their long-term financial positions.

Stockpiling cash

While an extra cushion can help a business weather downturns or fund unexpected repairs and maintenance, cash has a heavy carrying cost: the difference between the return that companies earn on their cash and the price they pay to obtain cash.

Checking accounts often earn no interest, for instance, and savings accounts may generate returns below 2%. Most cash "hoarders" will simultaneously carry debt on their balance sheets, such as mortgages, equipment loans and credit lines. They often pay higher interest rates on loans than what they're earning from their bank accounts. This spread indicates the carrying cost of cash. How much is too much?

Consider the question: What's the optimal amount of cash that should be kept in reserve? Unfortunately, there's no crystal ball that can indicate the current ratio or percentage of assets you can prescribe for your borrowers. A bank's liquidity covenants may provide an educated guess about what's reasonable.

But your bank can analyze how a customer's liquidity metrics change over time or how liquidity ratios compare to certain industry benchmarks. If you encounter huge increases in liquidity — or even ratios that are well above industry norms — that may indicate an inefficient deployment of capital.

When a customer's cash seems to be on the high side, suggest that the CFO or a CPA project financial statements for the next 12 to 18 months. A monthly projected balance sheet, for example, might estimate seasonal ebbs and flows in the borrower's cash cycle. A projection of a worst-case scenario can be used to establish the borrower's optimal cash balance. Keep in mind that projections must take into account the business's future capital expenditures, cash flows, working capital requirements and debt maturities.

Formal financial forecasts can provide a way to build up cash reserves, which is much better than relying on the borrower's "gut" instinct. Moreover, borrowers should compare their actual performance to projections and make needed adjustments.

Reinvesting cash surplus

It's critical that management look for ways to reinvest its cash surplus in order to earn a higher return. A borrower might choose to acquire a competitor — or its assets. A borrower with excess cash may be in prime position to profit from a competitor's failure. Formal due diligence is key for customers expanding via acquisition, to avoid impulsive, unsustainable projects.

The business can also invest in marketable securities. Cash accounts typically provide just a nominal return. In 2013 the FDIC will stop its unlimited insurance coverage for non-interest-bearing corporate accounts. Thus, more aggressive borrowers might choose to go with mutual funds or diversified stock and bond portfolios. A financial planner can help such borrowers choose securities.

Another key move is to repay debt. Doing so reduces the carrying cost of cash reserves. Lenders, of course, look favorably upon borrowers who try to reduce their debt-to-equity ratios.

Some businesses may also choose to use surplus cash to repurchase stock, especially when minority shareholders challenge the owner's decisions.

Use your gut instinct

Your borrowers likely excel at their daily business operations. But many rely on gut instinct to manage their administrative functions — including finance and accounting. Borrowers who are too conservative may need some professional insight into the highest and best use of their assets.

Take Caution when Evaluating Receivables of Lenders Dig Deep to Evaluate Risks

Author: Robert W. Wood, CPA

When vetting a commercial customer for a loan, you examine the company's financial statements to gauge the health of their receivables. You might consider this amount as collateral when you proceed with your lending decisions.

But beware: Some borrowers will exaggerate their receivables in order to get a loan. A savvy banker, however, will know what to look for on the receivables end so that they don't get duped in the process.

Watch for "ghost" sales

Banks typically monitor receivables from year to year. In addition, they compare receivables to sales with the days sales outstanding (DSO) ratio [(average receivables ÷ annual sales) × 365 days]. But certain expenses should also change in tandem with the receivables and sales, such as commissions and freight.

If these expenses don't change, it's possible that management is booking fictitious sales — which definitely warrants investigation. Also, be very skeptical of any business that reports huge improvements in gross margin. This is especially true when the DSO ratio has increased.

Determine which borrowers are at risk

It's risky for any company to rely on just one customer for more than 10% of its annual sales. What happens, for example, if a top client chooses an alternate supplier or strong-arms for more lenient payment or pricing terms? And what happens if a client files for bankruptcy?

Unfortunately, such concentration risks are quite common — especially among smaller businesses. That's why it's critical to identify your borrowers that suffer from concentration risk. Make sure you keep an eye on their key customers' financial performance and track the expiration dates of any exclusivity contracts or pricing commitments.

Dig deeper

A business's balance sheet should report accounts receivable as of a certain date. But that begs the question: What happens after the accounting period ends? You can get a much clearer picture of the condition of receivables by simply investigating how much of the outstanding invoices was paid or written off, how many credit memos were issued within a month of year end, and how many sales were reversed.

Because many receivables scams are reversed shortly after the accounting period, aggressive managers may scramble to inflate their receivables just at the end of the year. It's just common sense to pay close attention to a client's receivable journal entries made during the last few weeks of the year. If you see a significant increase in year-end account activity, it's likely that there's been some manipulation of receivables.

As you know, financial statements typically provide minimal information, so dig a bit deeper and ask for supplemental schedules, such as aging reports or sales decomposition reports. Ask borrowers to compare credit vs. cash sales or break down collections by salesperson, for example.

So long as you get permission, contact your borrowers' customers directly to confirm receivables. Confirmation letters can help protect against aggressive accounting practices, such as credit memo scams or fictitious revenue. When sent to a random sample of customers, confirmation letters can pin down whether specific invoices were outstanding as of a particular date.

Go the extra mile

If you go the extra mile with the due diligence described above, it's more likely that your estimation of customers' loan worthiness will be spot on. But if you take a customer's reporting of receivables at face value, you might be in for some unpleasant surprises.

Asset-Based Lending – Is It Time to Sever the Family Connection?

HOW QUESTIONABLE FAMILY BUSINESS PRACTICES CAN JEOPARDIZE DEBT SERVICE

Author: Howard Rein

As a lender, you've likely developed close ties with your family business clients. In fact, you might look at them as if they're an honorary member of the fold. But when you take the time to get to know family members, it's possible you'll unearth certain business practices that can jeopardize debt service. This is true especially when the business transitions to second generation ownership.

All in the family

Let's take a look at Sam, a homebuilder who decided to make his son, Ron, a superintendent for all jobs that would start in 2012. Ron had just graduated from college, so he wasn't quite as experienced as the previous supervisor. In addition, Sam paid Ron about 50% more per hour than his other employees. He hoped that this lucrative pay would help entice Ron to eventually take over the family business.

In a move that actually added to the company's overhead burden, the homebuilder employed his daughter, Lisa, as a landscape designer. Although Lisa had no formal training, she earned about $50,000 for her part-time landscape services in 2012.

So, what's the problem with this scenario? It's a well-known fact that a company's profits and quality can suffer when borrowers pay family members and/or friends at above-market rates or when related parties simply aren't qualified to do the work.

What you need to examine

As you can imagine, putting family members on the payroll is a prime example of a related-party transaction. As the lender, you should watch for other trouble spots, such as variable interest entities, related-party loans, commonly owned suppliers and customers, and quasi-business expenses.

Because some family businesses aren't as financially astute as others, you shouldn't expect each and every set of footnotes to disclose these transactions. It's critical that you ask management about any related parties and then evaluate whether all of the transactions that take place between related parties are at "arm's length."

For example, if one of your borrowers rents a home from a parent, you'll need to compare the rent per square foot to the rents for similar properties in terms of location, use and size. Also inquire whether the child is getting a family discount that's a quite a bit better deal than market price.

In addition, you need to evaluate how the related parties actually interact. If you note strained familial ties, for example, it can add a certain risk when loaning to a family business. Plus, there might be a "bad apple" in the family. Shifty family members may have a sense of entitlement and take advantage of their generous older relatives. If the family business has relaxed management styles and weak internal controls, it opens the door for dishonest relatives to "borrow" assets or exaggerate their timesheets.

Reducing the risk

As you know, not all related-party transactions are bad. In many ways, they're really quite normal. But you need to identify those relatives and friends who are involved in the business and then determine whether their interactions are occurring at fair market value. Do your due diligence, and gain peace of mind.

The Perfect Recipe for Fraud: Motive, Opportunity, and Rationalization

LOOKING FOR FRAUD IN ALL THE RIGHT PLACES: GUIDANCE FOR ASSET-BASED LENDERS

Author: Howard Rein

Fraud is most likely to occur in one of these departments: accounting, customer service, executive/upper management, operations, sales or purchasing — according to the Association of Certified Fraud Examiners (AFCE). In fact, in the ACFE's most recent Report to the Nations on Occupational Fraud and Abuse, some 77% of frauds are committed in at least one of these departments.

While most employees won't even consider fraudulent behavior, others may look at fraud as a great way to get ahead. So, what should you know about conditions that make fraud likely to happen?

3 conditions that can spark fraud

Just as fire requires fuel, oxygen, and heat, occupational fraud requires motive, opportunity and rationalization. These are what forensic accountants call the "fraud triangle." And economic downturns, such as the one we're currently in, can ignite fraud by fueling all three factors.

When you meet with borrowers or tour their facilities, make sure you look for circumstances that are ripe for misstatement or theft. For example, employees with upside-down home mortgages or unemployed spouses may rationalize the need to steal property and resell it. Unethical managers may try to conceal deteriorating financial performance with creative journal entries to avoid defaulting on a loan. Or they may try to inflate their sales record in order to preserve their bonuses (and their jobs).

Weak economy weakens resolve

The weak economy can also add opportunities to defraud. Layoffs typically spread remaining employees thinner, which can make it harder for companies to implement strong internal control procedures, like segregation of duties and supervisory review.

Owners and top managers alike may become distracted from fraud prevention and detection efforts as they scurry to focus on cost containment or recover lost sales. In addition, employees working harder without more pay might be more likely to rationalize a fraudulent act.

Controlling fraud

Lenders can make all the difference when it comes to controlling fraud. Let's look at a purely hypothetical case, in which a client's CFO used the recession to her advantage. In 2010, Laura secretly diverted some $80,000 in customer payments to her personal bank account. She then wrote off these amounts as bad debts, knowing that lenders and shareholders would expect poor results because of the lackluster economy.

When Laura's first scam went unnoticed, she colluded with a supplier to overcharge for materials. The fraudsters then split the difference between the invoice amount and the actual market value of the material. The owner blindly accepted the explanation that materials prices had increased because of rising energy prices. The fraud wasn't discovered until one very observant loan officer noticed that the business's profits had suffered disproportionately when compared to other borrowers in the same industry.

Be proactive

Detection efforts shouldn't wait until fraud appears on your doorstep. It's critical that you be proactive in meeting with borrowers to explain how the fraud triangle works and how it applies to them. Teach them appropriate internal control procedures, especially as borrowers try to cut costs. Warn them against taking internal control shortcuts — such as eliminating fraud reporting hotlines, training programs or job rotation.

Advise borrowers to watch for any changes in their employees' standards of living, personal behaviors (such as personal bankruptcy, drug abuse, divorce or gambling habits), or lifestyles. These may be warning signs that require a closer look at employee behavior.

Identify irregularities at the top

C-level fraud, in which owners and managers have complete authority to override a company's internal controls, is more costly and trickier, according to the ACFE. Such scams typically involve financial misstatement, which often leaves less physical evidence than an outright theft. In order to minimize fraud opportunity, lenders need to keep a diligent eye on owners, managers and the company's internal controls. Audits may be helpful, but they can't provide any guarantee against wrongdoing.

Regardless of the cause of fraud, be it mismanagement, fraud or macroeconomic misfortune, irregularities need to be identified and ultimately rectified. Lenders simply can't assume that conditions will improve when the economy gets back on track.

Keep your eyes open

It's quite obvious that owners and lenders alike must be diligent in looking for any signs of fraudulent behavior. Because the average fraudster will likely have no prior fraud charges or convictions, the fraudster just might be one of the last people that anyone would suspect.

Allowances for Doubtful Accounts

WHAT YOU SEE MIGHT NOT BE WHAT IT'S CRACKED UP TO BE

Guidance for Asset-Based Lenders

As you know, borrowers often pledge accounts receivable as collateral. But what you see on the business's balance sheet might not be what it collects — even if the company sets aside a certain allowance for doubtful accounts. Such allowances can be quite difficult to audit, particularly during economic turmoil.

Doubtful accounts

As you know, trade receivables are classified under current assets if a seller anticipates collecting them within the operating cycle or a year, whichever is longer. Unless the business sells services and goods exclusively for cash, some of those receivables will inevitably be uncollectible. So which methods should your company use when assessing an allowance for doubtful accounts?

Some companies will record their write-offs only when a specific account is truly uncollectible. This is called the direct write-off method. Even though it's an easy and convenient method, it doesn't match bad debt expense to the period's sales. In addition, it can actually overstate the value of accounts receivable on the balance sheet.

Many businesses turn to the allowance method to match revenues and expenses. With this method, the company estimates any uncollectible accounts as total outstanding receivables or a percentage of sales. The allowance shows up as a bad debt expense to offset sales on the income statement and as a contra-asset to offset receivables on the balance sheet.

Companies usually base the estimates on factors such as general economic conditions, receivables aging and the amount of bad debts in prior periods. Some businesses may also include allowances for unearned discounts, returns and finance charges.

Comparing apples to apples

An auditor will use several techniques to determine whether the allowance for doubtful accounts appears reasonable. Most begin with the company's aging schedule. The older a receivable is, the harder it will be to collect. A U.S. Department of Commerce study provides these guidelines for accounts receivable aging and collectability:

Age of receivable:	**Likelihood of uncollectability:**
30 days or less	4% uncollectible
31-60 days	10% uncollectible
61-90 days	17% uncollectible
91-120 days	26% uncollectible

Once accounts receivable aging goes beyond the four-month mark, the debts are extremely difficult to collect. And, of course, the actual collectability will vary by the economy, the industry, the company's credit policy and a myriad of other risk factors.

Statement on Auditing Standards (SAS) No. 57, Auditing Accounting Estimates (AICPA Accounting Unit Section 342), suggests that businesses compare their prior estimates for doubtful accounts with actual bad debt write-offs. For each accounting period, your ratio of bad debt expense to actual write-offs should be very close to 1. If one of your borrowers has several periods in which that ratio is lower than 1, beware: The company is overvaluing receivables and lowballing its estimate.

You'll also want to look at the business's exhaustion rate, which is how long the beginning-of-year allowance will cover actual write-offs. Suppose a company reported an allowance for doubtful accounts of $100,000 as of Jan. 1, 2011, and eventually writes off $70,000 in 2011 and $60,000 in 2012. The exhaustion rate would be as follows:

1.5 years ($100,000 - $70,000 = $30,000 left for 2012;
$30,000 / $60,000 = 0.5 years).

Opening the door to fraud

When you assess a company's allowance for doubtful accounts, understand that accounting estimates are subjective and might be used to manipulate earnings. How? Well, suppose one of your borrowers postponed write-offs indefinitely and reduced the allowance to artificially inflate its profits and collateral base. That's fraudulent behavior!

Dig deep and get help

If you find that a borrower's bad debts are rising, it's time to dig in and find out the root cause of the customer's bad debt. Other warning signs are that the business can't give you an estimate of an allowance for doubtful accounts, or the allowance just seems out of whack. In such cases, tap into your CPA's expertise to help you better assess the situation.

About Freed Maxick

Freed Maxick ABL Services is one of the nation's largest providers of ABL field exam outsourcing services to asset-based lending and other financial institutions that have granted loans, increased credit lines, reduced credit lines, or reduced loan loss exposure. The insights, observations and guidance presented in this whitepaper are based upon the experience of our Firm in helping asset-based lenders throughout our history.

Freed Maxick CPAs, P.C. advises public and private companies on ways to enhance profitability, save taxes, improve accountability and preserve wealth. We specialize in helping our clients discover and achieve their bottom-line potential and we provide sound business advice based upon our vast experience in a broad array of industry groups, including asset-based lenders, healthcare, manufacturing & distribution, governmental and not-for-profit.

Among the services we provide to companies looking to supplement asset-based lending departments with high level expertise and manpower:

- Accounting
- Auditing: Financial Statements, Compliance, Employee Benefit Plans, FAR
- Business Process Management Consulting
- Business Valuations
- Compilations and Reviews
- ERP / IT Systems Selection and Review
- Financing and Funding assistance
- Internal Control Strategies and Programs
- Merger and Acquisition Consulting
- Stock Ownership Compensation Planning
- Strategic, Operational and Financial Planning
- Tax Credits, Grants and Incentives
- Tax Planning and Strategies – corporate and individual

For more information on our asset-based lending services, visit FREEDMAXICK.COM, or call Howie Rein at 716.847.2651 today.

Trust earned.

FreedMaxick™
ABL SERVICES, LLC

Trust earned.

FreedMaxick™
ABL SERVICES, LLC

FREEDMAXICK.COM