

# The CPA Journal

## Auditing

### AUDITING

#### WHY FINANCIAL INSTITUTION FIELD EXAMINATIONS?

*By Steven M. Rosenberg*

Accountants and their borrower clients frequently ask lenders: Why is a field examination of the borrower's records required when the lender has been provided with financial statements on which the independent accountant has rendered an unqualified opinion. This is an important question, especially when the accountant has performed substantial work on the borrower's records to prepare their report on the financial statements. Furthermore, the borrower pays the independent accountant for their report on the financial statements in addition to the fee paid for a field examination.

Is the field examination just an unnecessary expenditure of time and money or a demonstration of the lender's distrust of the borrower or the borrower's current accountant? Usually neither. The primary reason for a field examination is to provide the lender with specific up-to-date information about a borrower's collateral that is being used to support the loan advances.

#### Background

Asset-based lenders and factors are the primary type of lenders that require field examinations, since accounts receivable and inventory are generally the primary assets that collateralize their loan advances.

In general, field examinations are required by lenders prior to the initial funding of a loan. The subsequent frequency of field examinations on a borrower's records vary from lender to lender but are primarily based upon the capitalization of the borrower. Borrowers that have capitalization in their company in excess of accounts receivable and inventory will experience less frequent field examinations because the excess capital provides the lender with additional collateral to repay a loan in case of a default. Conversely, loan advances to undercapitalized borrowers, that only have accounts receivable and inventory as collateral, will require more frequent field examinations due to the thin cushion of assets that can be used by the borrower to repay the loan.

#### The Goal of Financial Statements

The goal of financial statements is to present fairly, in all material respects, a borrower's financial position and results of operations and cash flows as a whole. The financial statements are intended to indicate to the reader how a borrower has performed over a specific period of time and what its financial position is at a certain date.

## The Goals of a Field Examination

***Eligible Accounts Receivable and Inventory.*** One of the goals of a field examination is to determine the "eligible" accounts receivable and inventory the lender will use as a base to make loan advances.

Eligible accounts receivable are those receivables the lender will expect to collect if a borrower defaults on its loan obligations. For example, accounts receivable considered "ineligible" could include accounts greater than 90 days past due, foreign accounts receivable, and accounts that may be set-off against accounts payable. These amounts might be considered difficult to collect in a bankruptcy or liquidation scenario. Financial statements do not identify these accounts to the reader.

Eligible inventory is more difficult to determine and its definition will vary among lenders. In many cases it is an estimate of the inventory's liquidation value. This is accomplished by excluding inventory items that would generate minimal to no value in a liquidation. For example, work-in-process would be extremely difficult to sell in an unfinished state. The same can be said for slow moving inventory, since it has not been sold under current market conditions.

***Performance of Collateral.*** A second goal of a field examination is to analyze the current performance of the collateral being used to support a loan. One of the procedures of a field examination is to determine the accounts receivable turnover. This allows the lender to gauge whether their loan advances will be repaid in 30 days, 75 days, or more. Another procedure is to determine the concentration of customers that make up the accounts receivable balance. This allows the lender to determine how heavily a borrower relies on certain customers. The lender then has the ability to determine the credit worthiness of those customers. A field examination also indicates inventory by its location. This provides the lender with the ability to gather the inventory in the event of a liquidation.

***Assurance.*** A third goal of a field examination is to determine that the information being supplied to the lender on a periodic basis is accurate. Certain types of loans, particularly asset-based loans, require that a borrower provide the lender with collateral information on a monthly basis. This collateral information is provided to the lender in the form of a borrowing base certificate. In general, a borrowing base certificate indicates gross accounts receivable and gross inventory values, less items previously established as ineligible. One of the steps in a field examination is to reconcile the borrowing base certificate to the supporting accounts receivable aging report and the perpetual inventory report and to determine the borrower is not understating the ineligible items.

### Both Are Needed

Financial statements indicate the performance of a borrower as a whole. The collateral examination is not used by the lender as a substitute for the financial statements, but instead it is used by the lender to obtain the specific up-to-date analyses of the borrower's collateral and net liquidation value. Both the financial statements and collateral examination are an important, integral part of the decision making process used by the lender in evaluating the credit facility extended to a borrower. \*

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