What is the Purpose of a Lender's Field Examination?

by Steven M. Rosenberg

Field examinations provide specific and timely facts to the lender regarding the borrower's collateral. The results of the field examination are used by the lender in conjunction with the CPA's financial statements to help the lender manage its relationship with the borrower.

Some asset-based lenders and factors maintain their own internal staff of field examiners, while others engage outside firms to perform the examinations. The outside firms are generally CPA firms, consulting firms or sole independent contractors. Field examiners are generally accountants, former lenders or CPAs.

Lenders primarily rely on field examinations for the following reasons:

- ➤ Analysis of the borrowing base certificate;
- ➤ Detailed description of the collateral, its eligibility and its performance;
- ➤ Description of the bookkeeping procedures related to the collateral and underlying controls;
- ➤ Status of the accounts payable and related liabilities that affect the borrower's collateral;
- ➤ Timeliness of the field examination;
- ➤ Eyes and ears of the lender;
- ➤ Liquidation scenario.

Analysis of the borrowing base certificate

When loans are secured by accounts receivable and inventory, the lender frequently requires the borrower to complete periodic borrowing base certificates (typically monthly). A borrowing base certificate illustrates a borrower's eligible collateral (accounts receivable and inventory) compared to the existing loan balance. The result is either that the collateral is more or less than the loan balance. The certificate illustrates to the lender if the borrower's loan balance is protected by the borrower's secured working-capital assets.

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In general, the borrowing base parameters are set up by the lender at the beginning of the relationship. The main parameters include (1) gross accounts receivable and inventory balances, (2) amounts that are considered ineligible to lend upon and (3) the advance rates on eligible collateral.

Gross accounts receivable is generally based on the total accounts receivable aging report at a given date. Gross inventory is generally based on the perpetual inventory report at a given date (usually month-end).

Ineligible accounts receivable are typically accounts that would be difficult to collect in a liquidation scenario. These accounts include, but are not limited to, accounts greater than 90 days past due, intercompany and related company accounts, foreign accounts receivable not supported by letters of credit, credit insurance or another form of payment guarantee and accounts where there is an offsetting accounts payable balance with the customer.

Ineligible inventory are items that would not be readily saleable in a liquidation scenario. These inventory items include, but are not limited to, work-in-process, inventory over one year old and customer-specific type packaging.

The advance rate is a percentage that is applied to the eligible collateral to determine the borrowing limits. Advance rates should provide the lender with a cushion to absorb any unforeseen collateral deficiencies and additional collection costs. In general, advance rates range from 60 percent to 90 percent for accounts receivable and 10 percent to 50 percent for commercial, noncommodity-type inventory. Advances are usually determined or adjusted from information gathered in the field exam report.

To illustrate the borrowing base calculation, assume at July 31, 2002 that gross accounts receivable is $100 (with $15 over 90 days) and gross inventory is $75 (with $10 over one-year old). Advance rates are 80 percent for accounts receivable and 40 percent for inventory. The loan balance was $85. The following table illustrates the sample borrowing base, which resulted in excess collateral availability of $9:

Accounts receivable aging report as of July 31, 2002:	$ 100
Less:	
Accounts receivable greater than 90 days from invoice date	(15)
Eligible accounts receivable	85
Advance rate	80%
Available accounts receivable	68
Perpetual inventory as of July 31, 2002:	75
Less:	
Slow-moving inventory	(10)
Eligible inventory	65
Advance rate	40%
Available inventory	26
Available collateral	94
Loan balance	85
Availability excess / (shortfall)	$ 9

Detailed description of the collateral, its eligibility and its performance

Field examinations focus primarily on the quality and the performance of the borrower's accounts receivable and inventory. The performance of the collateral has a direct effect on the net borrowing availability based on the advance rates and eligible collateral.

Accounts receivable: Field examination reports illustrate the spread of the current accounts receivable aging compared to historical aged balances. This helps the lender determine the trend of the accounts receivable. For example, say the over-90 days balance on the accounts receivable aging has increased from quarter to quarter for the past year. It would appear that the quality of the accounts receivable is declining.

The report also includes the top customer aged balances compared to the total balance. This enables the lender to determine whether

there is a customer concentration and whether the customers are creditworthy. Lenders are generally not in favor of significant customer concentrations, especially customers with poor credit, since the loss of a single customer would cause a significant decline of revenue and profits.

The field examination report provides a detailed calculation of accounts receivable turnover and the average net collection of the accounts receivable (i.e., accounts receivable collected after credits, returns, deductions and bad debts, also known as dilution). In particular, the dilution statistic helps the lender determine the advance rates. For example, if customer credit memos increased to an average of ten percent of gross sales (net collections being 90 percent) from one percent of sales, then the lender would be inclined to lower the advance rate on the accounts receivable because the lender expects to collect less of the borrower's gross accounts receivable should the borrower enter into a liquidation scenario.

Inventory: Field examinations indicate the stage of inventory (if it is manufactured) and where it is located. Work-in-process or inventory located in a foreign warehouse may have significantly less value to a lender than finished goods located in a domestic warehouse. In the event that the lender has to liquidate the inventory, it would be much easier to resell finished goods located in a domestic warehouse.

Field examinations also illustrate inventory turnover. The result of this calculation generally has a direct impact on the marketability of the inventory. In general, field examiners specifically attempt to determine inventory by age and may consider inventory over one-year old as ineligible. The assumption is that if the inventory has not been sold in the ordinary course of business within the past year, it would not be readily marketable at the current value should it have to be liquidated.

In addition, field examination reports compare the inventory value by location to its insured value. Uninsured inventory may be considered ineligible, since it would have no value if destroyed in a fire or another unforeseen event.

Description of the bookkeeping procedures related to the collateral and underlying controls

Accounts receivable: The field examination report generally includes a description of the accounts receivable accounting system (how transactions are processed from customer order to customer remittance), description of the accounts receivable aging, terms of sale and credit policy. This helps the lender understand the flow of the documents and provides the lender with a better perspective of the accounts receivable aging.

For example, a field exam indicates whether an accounts receivable aging is invoice-date-, or due-date-based and the terms of sale. This can have a significant impact on the actual age of the account balance. Accounts receivable agings that are invoice-date-based age the invoice from its date of generation (an invoice that is 35 days old would be in the 30-60 days column). Due-date-based accounts receivable agings age the invoice based on the date it is due. Assume that an invoice has 90-day terms. It would be in the current column for the first 90 days and, when it advances to the over 90-day column, it would have been in excess of 180 days from generation. This is important information for a lender who considers all invoices over 90 days from generation as ineligible, regardless if they are due or not.

Inventory: Field exams discuss the flow of inventory, how it is valued in each stage (if manufactured), where it is located, obsolescence policy and reporting capabilities.

One of the simplest, but most important, aspects of inventory reporting considers whether the inventory is accounted for using the periodic or perpetual method. Borrowers using a periodic method are estimating the inventory based on a count from a prior period (usually year-end). In a borrowing-base situation, lenders generally require that the inventory be maintained on a perpetual system. This allows the borrower, and subsequently the lender, to determine the inventory value at any date and time.

Status of the accounts payable and related liabilities that affect the borrower's collateral

Similar to the accounts receivable analysis, the field examinations illustrate the accounts payable concentrations and historical aging comparisons. The concentration illustrates the borrower's suppliers, the amount due to the suppliers and the age of the payables. Borrowers who are dependent on single suppliers may be cut-off from shipments if they let the accounts payable get too old. The historical aging reports illustrate to the lender how the payables are performing and the direction of the trend.

Field exams also determine whether the borrower is current on federal payroll taxes. One of the few liabilities that can become senior to secured collateral debt is unpaid federal payroll taxes.

Timeliness of the field examination

In general, field examinations are performed on the most recent month-end. Draft field exam reports can be provided to the lenders as early as a week after the examiner leaves the borrower's premises. Field examiners often relay certain information to the lender while they are on-site at the borrower. Astute field examiners often look beyond the numbers and provide insights into the borrower's operations.

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Since asset-based loans are so reliant on accounts receivable and inventory, current information is critical. Borrowers in cyclical industries can have very different accounts receivable and inventory structure at different times of the year. For example, borrowers in the apparel and toy industries can have significant inventory and minimal accounts receivable in the summer and fall and significant accounts receivable and minimal inventory in the winter and beginning of spring. As a result, financial statements that are only 60 days old may not accurately portray the current working capital structure of a borrower if the borrower had recently finished its sales cycle.

Eyes and ears of the lender

Depending on the lender and the leverage of the borrower, the frequency of field exams can vary. For example, certain lenders only require a field exam prior to an initial funding or when the borrower requests a line increase. Others perform them annually, but for highly leveraged borrowers some lenders require quarterly field exams.

Field examiners are the eyes and ears of the lender and they will report back observations that may be unrelated to the actual analysis, but nonetheless would be helpful to the lender.

Liquidation scenario

In general, a field examination aids the lender in determining if the accounts receivable and inventory are enough to cover the outstanding loan balance in a liquidation scenario.

All the procedures performed during the field exam help the examiner prepare the schedule of availability, which indicates the excess or shortfall of available collateral compared to the loan balance.

Cushions are built into the schedule of availability to absorb expected and unexpected collateral deterioration should a borrower have to be liquidated. For the accounts receivable, the expected deterioration includes ineligible accounts that the borrower would not expect to collect should they stop operating. The advance rate, assuming 80 percent, provides the lender with a 20 percent cushion for dilution and unexpected accounts receivable losses. The same is true for the inventory. Expected deterioration includes ineligible items that would not be sold as is in the ordinary course of business. The advance rate, assuming 40 percent, provides the lender with a 60 percent cushion for inventory sold in bulk at a discount. ▲

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