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Financial Lending Notes

A Newsletter for Commercial Lenders

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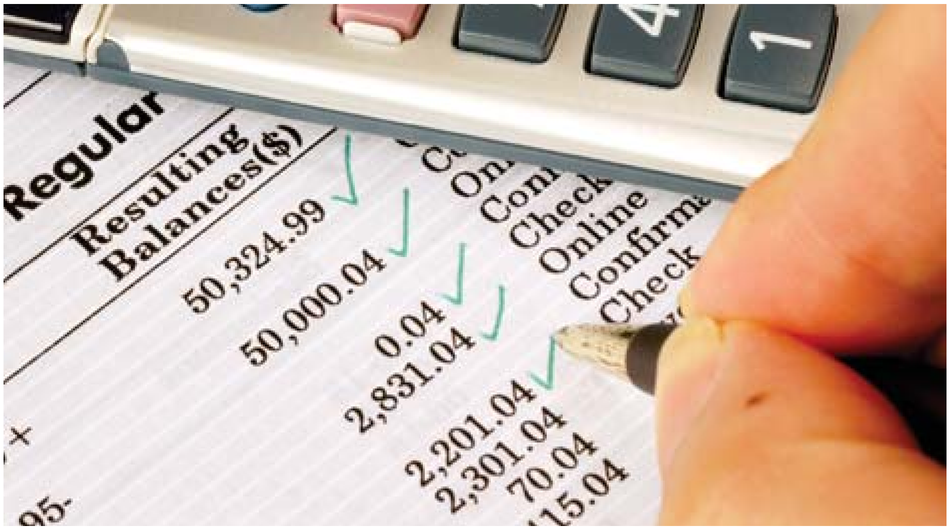
Contractor Accounting

Understanding the Nuances of Lending to Contractors

Lending to contractors presents special challenges for banks due to the nuances involved in contractor accounting. This is important to remember now as activity in the construction industry has picked up again after spending years in the doldrums in the aftermath of the recession.



Contractor Accounting Methods

Contractors can use one of two accounting methods: the *completed contract* method or the *percentage of completion* method. Many contractors use the former method for tax purposes and the latter method for book purposes.

With the percentage of completion method, revenue and costs are recognized as the job progresses, based on engineering estimates or the percentage of costs realized compared to estimated costs. For example, the foundation is 10 percent complete or steel is 25 percent complete. At these points, the contractor recognizes the appropriate percentage of revenue and estimates the approximate percentage of cost.

Unfortunately, recognition of revenue isn't necessarily a true reflection of the contractor's cash flow. So while 25 percent of a contract may have been billed because the job is 25 percent complete, the contractor may have only spent 10 percent of the money.

This results in what's known as *billings in excess of cost*. Conversely, a contractor may have done work it hasn't billed yet, which is known as *cost in excess of billings*. The former is listed as a liability and the latter is listed as an asset on the balance sheet.

Meanwhile, with the completed contract method of accounting, all costs accumulate on the balance sheet as work in process until the job is complete, at which point revenue and expenses are recognized.

The Job Status Report

The best way for a lender to analyze a contractor's financial statements and thus make an informed lending decision is to receive and monitor a summary of jobs or job status report, preferably on a monthly basis. This job summary should include:

- Contract name, number and amount;
- Percentage complete;
- Amount of revenue and cost recognized to date;
- Profit or loss recognized to date;
- Estimated cost to complete and;
- Estimated or actual profit or loss.

Any good contractor should be able to compile this monthly job status report — easy-to-use templates are readily available online. If a contractor balks, it may be trying to hide problems with some (or all) of its jobs.

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SBA Lending

How SBA Loans Can Benefit Borrowers and Your Bank

Most community banks desire to make loans to small businesses in order to help support their communities and, of course, boost bank profits. But not every small business that applies for a loan will be approved.

Fortunately, there's an alternative to traditional loans that could enable your bank to say "yes" to small businesses you might otherwise have to decline for a loan. We're talking about loans guaranteed by the U.S. Small Business Administration (SBA). The SBA guarantee of a portion of the loan enables banks to lend money to some small businesses that wouldn't qualify for financing based on normal underwriting guidelines.

Types of SBA Loans

There are three main types of SBA loans:

7(a) Loans
The SBA's most common loan program, these loans of up to $5 million can be used to start, expand or acquire a business.

CDC 504 Loans
These loans of up to $5.5 million provide long-term fixed-rate financing for major fixed assets like equipment, land and buildings.

Microloans
These provide very small (up to $50,000) short-term loans to new and startup small businesses.

Banks and Borrowers Benefit

SBA loans can benefit both banks and small business borrowers. For banks, they may be a good way to put new loans on the books, which will result in higher small business loan approval rates.

In fact, SBA loans are proving to be a lucrative funding vehicle for many community banks today by providing healthy margins and the opportunity to earn additional fee income via servicing and gain on sale. This is true whether your bank holds onto SBA loans or sells the guaranteed portion of the loans into the secondary market.

Selling SBA loans will provide additional liquidity that enables you to make even more small business loans, while holding them could enable you to leverage your capital and reduce portfolio risk. Guaranteed portions of SBA loans are generally subject to zero-percent risk weighting for capital purposes. In today's environment, many banks are finding that the potential for gain on sale outweighs the benefits of holding onto the guaranteed portion of SBA loans.

For small businesses, SBA loans can be a lifeline to finance much-needed growth and expansion. An SBA loan may be appropriate for a small business that is highly leveraged and has limited liquidity and weak collateral. If there is a viable core business in place and owners can provide projections demonstrating the ability to repay the loan, the business could be a perfect candidate for an SBA loan.

Pay Attention to Loan Servicing

Servicing is critical when making SBA loans because, like any guarantor, the SBA doesn't like writing checks if it doesn't have to. Stringent rules, including strict monitoring and reporting requirements, must be followed carefully in order to claim the SBA guarantee on a loan gone bad.

In this scenario, the first thing the SBA is likely to do is determine if your bank followed standard operating procedures as detailed in SOP 50 10 5(F). For example:

- Has the minimum debt service coverage of 1.15 on both a historical and projected basis been achieved for SBA loans of $350,000 or more?
- Have principals pledged personally owned real estate as collateral on SBA loans that are not otherwise fully secured?
- Was equipment valued at up to 80 percent of orderly liquidation value and real estate at 85 percent of appraised value for purposes of securing the loan?
- Were the borrower's financial statements current within 180 days of the loan application?
- Did you obtain and analyze annual financial statements from the borrower and perform annual property inspections?

Infrastructure and Expertise Are Critical

It's important to make sure your bank has the appropriate infrastructure in place before embarking on an SBA lending initiative. You should also hire an expert who specializes in SBA lending if you don't currently have one on staff. This individual should understand all the nuances involved in SBA loan underwriting, monitoring, servicing, SOPs and the like.

Give us a call if you would like to discuss the benefits of SBA loans to your bank and your borrowers in more detail.

Understanding the Nuances of Contractor Accounting

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As you analyze the job status report, pay especially close attention to the following areas:

Percentage of contract completion — If most or all of the jobs have a high percentage of completion, such as 90 percent or higher, this may indicate that the contractor has little if any backlog and, hence, future revenue.

Conversely, if you see low percentages of completion compared to revenue recognized — such as 20 percent completion but 50 percent revenue recognized — this likely indicates that the contractor is front-ending jobs. While this is good news for cash flow, you need to make sure the contractor isn't using revenue from the job for other purposes, like to finish another job or buy new equipment.

Percentage of accounts receivable that is retainage — This is the portion of payment customers hold back until a job is completed and a certificate of occupancy is issued. It's usually between 10 percent and 20 percent of the total, which represents the profit on many jobs.

Retainage should be recorded as billed but reported separately in the accounting records from progress billings currently due. It should only be recorded as a current receivable after the job is finished and a certificate of occupancy is issued. This will be disclosed on audited financial statements.

Purchased but uninstalled materials — Materials that have been purchased and charged to a contract but not installed yet should not be counted toward the percentage of contract completion. Instead, they should be excluded from actual costs before computing the percentage of completion.

Accuracy of contractor projections — How well did the contractor estimate costs and revenue when bidding the job? What was the end result — a profit that met or exceeded projections or one that came up short, perhaps even resulting in a loss?

Based on the answers to these questions, you may need to carefully assess the competency of a contractor's estimator, as well as the contractor's ability to manage the job. In addition, assess the contractor's history of completing jobs on time and on budget while paying all subcontractors in a timely manner.

Lending Against Contractor Receivables

In general, it's not advisable to lend money secured by contractor receivables. These receivables, or billings for work in progress, are often contingent on the work being completed — so if the job isn't finished, the receivables won't be collected.

And on bonded jobs, the bonding company has the right of subrogation, or first claim on the receivables. This gives the bonding company payment priority over a bank's right of assignment. So in most instances, lenders should only loan money secured by a contractor's equipment.

You should also be wary if a general contractor ever needs to draw down its line of credit. GCs live off of their subcontractors, who incur most of the job costs. So if GCs have cash flow problems, they've usually done something else with the money — for example, they've funded losses, bought new equipment or used cash to support their lifestyle.

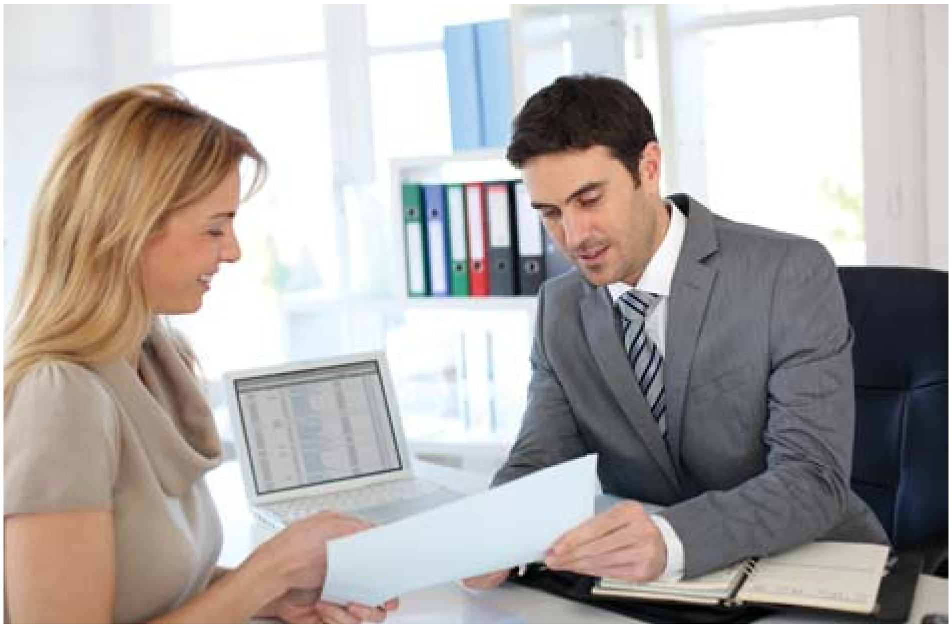
This doesn't mean, though, that you shouldn't give GCs lines of credit. These can be very profitable relationships: They provide steady fee income and the lines are rarely used, while GCs tend to maintain large deposits. But keep a close eye out for GCs who might be getting into financial trouble.

Start Preparing Now

From a historical perspective, some of the problems discussed here start to crop up in the late stages of an economic recovery or early stages of a recession.

Given where we are in the economic cycle — the current recovery has been going on for 98 months, making it the third-longest recovery on record — it would be wise to prepare now for how your bank will deal with potential problems like these in the months or years to come.

Please contact us if you have more questions about contractor accounting.



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Watch Out for E-mail Compromise Fraud Schemes

Banks and their customers are increasingly being victimized by e-mail compromise fraud schemes in which cybercriminals misappropriate funds via fraudulent wire transfers. According to the Financial Crimes Enforcement Network (FinCEN), there have been approximately 22,000 reported cases of e-mail compromise fraud schemes since 2013 involving $3.1 billion.

In a special Advisory to Financial Institutions, FinCEN detailed how these schemes work. Cybercriminals use social engineering or computer intrusion techniques to compromise victims' commercial and personal e-mail accounts in order to obtain sensitive bank account information.

Once they have this information, criminals send fraudulent wire transfer instructions to the bank that look like they came from the victim. The instructions direct the bank to wire money to the criminal's account, commonly located in an Asian bank, especially in China or Hong Kong.

The best way for banks to detect and prevent e-mail compromise fraud schemes like this is to carefully review and verify all wire transfer instructions (including out-of-bank verification) and initiate strong call-back procedures. You should also consider the circumstances surrounding these instructions.

The Advisory also listed a number of red flags that could indicate this type of fraud, such as the following:

- Transaction instructions include a different language, timing and amount than previously.
- The beneficiary's account information is slightly different from the information contained in previously verified instructions.
- Transaction instructions contain trigger language like "Urgent," "Secret" or "Confidential."
- Transaction instructions direct that payment be made to a beneficiary the customer has no payment history or documented business relationship with.

If your bank has been victimized by an e-mail compromise fraud scheme, you can file a complaint with the FBI's IC3 by visiting http://www.ic3.gov. Keep in mind that you may also have Suspicious Activity Report (SAR) filing obligations.

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