

Research Series
Private Company

What Do Users of Private Company Financial Statements Want?

Published by
Financial Executives
Research Foundation

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What Do Users of Private Company Financial Statements Want?

Purpose

This Executive Report summarizes a series of interviews with preparers of financial statements and commercial and investment bankers that sought to answer the question, what do users of private company financial statements want? It has been prepared with Financial Executives International's Committee on Private Companies for FEI members and others and has been sponsored by the NFIB Research Foundation.

Executive Summary

The following themes emerged from the interviews:

Internal Management

- Internal managers receive financial and operating information for their businesses.
- This information is not in the format of full-disclosure, financial statements prepared according to generally accepted accounting principles (GAAP).
- Operating information is provided on both a weekly and a monthly basis.

Bankers

- Banks want annual audited GAAP financial statements for accuracy and comparability, and they also want quarterly financial statements.
- Other financial information that may be provided includes:
 - Detailed aged payables, receivables and inventory.
 - Monthly loan covenant calculations (debt to tangible net worth and current ratio calculations).
 - Collateral reports, and
 - Quarterly cash flow coverage information.
- Data from financial statements are entered into computer models and databases to measure liquidity and monitor compliance with debt covenants.

Investment Bankers

- Want audited annual GAAP financial statements for accuracy and comparability.
- Want supplemental information beyond GAAP, such as a history of capital expenditures.
- A fair value appraisal will be required if a company is not liquid. This is not necessary for a financially strong company.

Investors

- Want more information than is provided by financials prepared in accordance with GAAP.
- Are more interested in operating data than financial data.
- Consider trend lines and year-over-year comparisons to be important.

Use of GAAP

- GAAP does not provide the detail needed by investors or even banks.
- Certain calculations are difficult and time consuming (Ex. FIN 46).

Debt Covenants

- Debt covenants are not always standardized and are often based on the borrower's industry.
- Financial information required by debt covenants includes cash earnings (earnings before interest, taxes, depreciation, and amortization or EBITDA), cash flow and tangible net worth, which excludes non-cash intangible assets such as goodwill.
- EBITDA, as a proxy for cash earnings, is very important to banks. Financial statements should segregate depreciation and amortization so that they can be added back to net income to calculate EBITDA.
- Some debt covenants may include maintaining certain ratios:
 - Leverage: total liabilities divided by tangible net worth should be less than three to one; and
 - Earnings or cash flow: funded debt divided by EBITDA should be less than three to one.
- Debt covenants may require that the company maintain a minimum targeted tangible net worth and maintain a ratio of debt to tangible net worth that is less than a targeted percentage, again depending on the industry.
- Banks may also require that borrowers maintain a minimum debt service coverage, often defined as the ratio of net income plus non-cash charges to current maturities of long-term debt plus interest.

Internal Controls

- The only users that have requested compliance with Sarbanes-Oxley are investment bankers, in anticipation of a sale of a company or an initial public offering (IPO).

Introduction

Most financial executives would agree that serving the needs of the users of financial statements is one of the primary objectives of financial reporting. Broadly speaking, users of financial statements can be categorized as internal and external. Internal users include company management, owners and directors. External users can be further categorized into two groups:

1. Commercial and investment bankers, insurance companies, leasing companies, vendors and suppliers who are primarily concerned with the company's collateral and credit worthiness.
2. External shareholders and potential investors who may be more concerned about share values, dividends and future earnings.

For private companies, what are these users' needs? Once these needs are identified, how do they drive demands for financial information? In a series of interviews, FERF's research staff examined the answers to these questions from the perspectives of both users and preparers.

Research Methodology

During March and April 2006, FERF staff either interviewed or surveyed seven preparers of financial statement from private companies, nine commercial bankers and two small, boutique investment bankers. The bankers and preparers were asked a similar series of questions.

The responses of the preparers are summarized on the following pages as Company A, B, C, D, E, F and G. The responses of the commercial bankers are summarized as Bank A, B, C, D, E, F, G, H and I. The responses of the investment bankers are summarized as Investment Bank A and B.

The responses of the **preparers** are organized with the following outline:

Internal Financial Statements

- Managers
- Owners and Investors

External Financial Statements

- Banks
- Insurance Companies
- Vendors
- Other

Use of GAAP

Debt Covenants

Use of Fair Value

Internal Controls

The responses of the **commercial** and **investment bankers** are organized with this outline:

Required Financial Information

Requested Financial Information

Use of GAAP

Debt Covenants

Use of Fair Value

Internal Controls

Company A

Company A is a small medical device manufacturer. It is owned by over 300 physician shareholders and a venture capital firm. The company is committed to going public.

Company A has a total of seven employees. There are four directors on its board. The acting CEO is on the board and is the only director with financial expertise.

The acting CEO was interviewed for this report.

Internal Financial Statements

We prepare financial statements in accordance with GAAP, and they are audited every year. This is required by our institutional investor, but we would have done it anyway.

Typically, we send out a stockholder letter every two months that has non-financial information on where we are getting financing and where we stand with the Food and Drug Administration on patents. The most important metric is the timetable to commercialization (how long to revenue).

External Financial Statements

We provide financial statements to anyone who provides capital and anyone doing due diligence. Up until now, this has been mainly investors who provide equity capital and convertible bridge notes as debt. We also provide financial information in connection with our solicitation for this capital.

Use of GAAP

We prepare financial statements in accordance with GAAP. We have some problems accounting for options and warrants. These are examples of equity accounting, which is even problematic for many public companies.

Use of Fair Value

The utility of fair value depends on the nature of the business that you are in. One reason to use fair value would be to account for an acquisition in accordance with Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS) No. 141, Business Combinations and SFAS 142, Goodwill and Other Intangible Assets, to identify intangibles and goodwill. Another reason to use fair value is in real estate.

Internal Controls

I have issues with Sarbanes-Oxley, and I support the recommendations of the SEC advisory committee that smaller companies be exempted. Sometimes smaller companies are the ones that investors need to be protected against because of fraud. But I don't think that Sarbanes-Oxley will be a deterrent to that. Eventually, I see public companies delisting, which could close off the capital markets.

I have our controller focused on how to get maximum controls with just seven employees. The greatest control, and also the greatest potential source of fraud, is the CEO review of the financial statements. We have one independent director on our board, and we use an outside law firm as our general counsel.

Company B

Company B is a mid-size high-tech manufacturer. It is owned by a limited liability company (LLC) that is a multi-generational trust. The company has no plans to go public.

Company B has about 2,500 employees. The LLC has seven managers who act as the board. No board members would be considered to have financial expertise.

The CFO was interviewed for this report.

Internal Financial Statements

To operate effectively, we find that good cash flow is our main objective. We want timeliness in our financial statements, so we issue them four days after month end and communicate them to an internal management group and the owners. Internal incentive plans are based on financial statements.

The internal statements include balance sheet, income statement and cash flow. These statements are presented for each operating entity and on a consolidated basis. Supplemental information such as days sales outstanding, inventory turns and backlog are also provided.

The board meets quarterly with the LLC, and they review non-cash adjustments to the GAAP financials at the meetings.

External Financial Statements

We have a “hands-off” lender that provided a long-term debt private placement. It requires audited GAAP financial statements 150 days after year end.

We also do modest borrowing from a commercial bank. The commercial bank receives audited GAAP financial statements. Quarterly financial information is also provided for covenant calculations.

Use of GAAP

I don't like the idea of two sets of GAAP standards. Two sets rather than just one is a fundamentally wrong idea. But I do like the idea of different footnotes for private companies and public companies. I would rather live with complexity than have two sets of GAAP, and I am worried that foreign stock exchanges will attract companies to list with them rather than in the US, because their regulations are less complex.

Three aspects of GAAP accounting cause us frustration:

1. Goodwill and intangibles: The family owners have a good sense of the business and don't see accounting for intangibles as adding value to the business;
2. Deferred taxes: These deferred taxes are impossible to reconcile because there were large net operating losses in the past but tax payments were small;
3. Lease accounting for discontinued operations: The accruals change each year based on new information.

These aspects don't affect the quality of our financial statements for managing the business on an ongoing basis, and they don't affect the quality of information about working capital and cash flow from operations.

Debt Covenants

For the loan covenants, we provide a quarterly consolidated balance sheet, an income statement and a statement of cash flows. Annually, we provide a plan and the audited financial statements. The quarterly compliance certificate includes the following:

- Calculation of debt to earnings before interest, taxes, depreciation and amortization (EBITDA),
- Disclosure of restricted payments, and
- Calculation of net worth.

Use of Fair Value

I like fair value for financial analysis but not for financial statements.

Internal Controls

We have both awareness of and appreciation for good internal controls. We have an internal audit department, and our board expects good internal controls.

Company C

Company C is a mid-size health care provider. It is entirely owned by the employees, with one-third of the company owned by a frozen employee stock ownership plan (ESOP). Three long-term employees own a controlling share of the company. There are no current plans to go public.

Company C has a total of 2,500 employees. There are 14 directors on the board, all members of senior management. In addition to the CFO, three other directors have financial expertise.

The CFO, who is one of the three long-term employees, was interviewed for this report.

Internal Financial Statements

Monthly financial reports are prepared for each profit center. These reports are basically modified cash reports and go to all department heads who are stockholders.

Quarterly financial statements are prepared for the board of directors. This includes the balance sheet, income statement and cash flow statement

External Financial Statements

The same quarterly financial statements prepared for the board of directors are sent to our bankers, an investment bank and an appraiser. Our commercial bank requires us to submit unaudited quarterly financial statements and an annual audited financial statement.

Use of GAAP

The annual financial statements have exceptions to GAAP associated with FASB Staff Position (FSP) 150, FASB Interpretation (FIN) 46, or Statement of Financial Accounting Standards (FAS) 133. The banks have agreed that these standards are irrelevant to our financial position, and the lending agreement does not require compliance.

Debt Covenants

In addition to the financial statements, we provide information for three financial covenants to our commercial banks: tangible net worth (as defined in the agreement), the debt-to-equity ratio and cash-to-debt service.

There is also a limit to the amount of off-balance sheet investments that we can make (which is two times equity).

Use of Fair Value

Annually, the investment bank values the company stock for the ESOP. It uses GAAP as a starting point. Fair value accounting is used for asset impairment.

Internal Controls

Even before Sarbanes-Oxley, we had an audit committee. The audit committee always looked at internal controls, and our controllers had to deal with these issues.

Sarbanes-Oxley has caused our company's total audit fees to rise 40% over three years. We have been treated as if we were a public company.

Company D

Company D is a small retailer. It is 97% family owned, with the other 3% owned by the employees. The company could decide to go public some time in the future.

The CFO was interviewed for this report.

Internal Financial Statements

Financial statements are prepared from a management point of view, and GAAP is not necessary. These internal management financial statements are then adjusted for external purposes.

As an example, rent is expensed internally on a straight-line basis. But for GAAP, you divide total rent payments over the life of the lease by the number of months. Because the lease has “step ups” over time, GAAP rent expense is greater than rent on a cash flow basis.

The internal financial statements show profit and loss, inventory, accounts payable and the ownership of buildings.

External Financial Statements

Factors require financial information to make sure they can accept our credit. Our vendors sell their accounts receivable to the factors and to banks.

Some landlords will ask for financial statements, particularly new landlords if we are opening a new store. They want to be sure that we can pay the rent before they make any commitments. If they have to make improvements to the building, they want to make sure it is worth their investment. Existing landlords don't ask for financial statements.

GAAP is required, but private company users are more interested in cash flow and debt coverage.

Our company has a credit revolver with a bank syndicate that is considered low risk since we have no other debt. The bank requires audited financial statements that comply with GAAP. We also provide a one-year and two-year forecast and quarterly financials.

Use of GAAP

(Refer to “Internal and External Financial Statements” above)

Debt Covenants

The formulas used as a basis for our quarterly covenant calculations are negotiated with our bank. The calculations include the ratio of current debt to six times rent and the ratio of EBITDA to debt.

Company E

Company E is a mid-size mining company. As for ownership, 46.5% of the company is owned by the CEO, 46.5% is owned by an outside investor group, and the remaining 7% is owned by others. Both the CEO and the investor group would like to take the company public.

Company E has a total of 892 employees. There are five directors on the board, including the CEO, the CFO, two representatives of the outside investor group and an independent (outside) director. All five have financial expertise.

The Vice President, Controller was interviewed for this report.

Internal Financial Statements

We use a standard income statement format showing monthly, quarterly and year-to-date variance from budget. There is no balance sheet analysis.

The CEO and the investor group want more information than is provided by financial statements. They want monthly operational data.

Management prepares a monthly PowerPoint presentation with graphs of operating information for the investors, and the financials are at the very end, because operating information is more important to them than financial information. The graphs show such measures as tons produced and tons sold by month vs. plan and vs. the prior year, coal inventory, and equipment productivity. Financial information, provided after operational data, includes EBITDA, sales by month, capital expenditures, cash, working capital, aged receivables and trade payables.

We see financial statements as only a portion of our communication with investors, bankers and others. For many users, there is a need to place typical financial information into a different context. For example, for some users we convert our sales to a per-ton basis and exclude the freight component, resulting in a much different measure than one would get from GAAP financial statements that are required to include customer freight in the sales line. On the other hand, other users are not looking for the same level of detail, in which case GAAP financial statements in the traditional format are adequate.

External Financial Statements

We prepare financial statements for a group of banks. The banks want annual audited GAAP financial statements, quarterly financial statements and measures (ratios) of liquidity, which are specified in the debt covenants.

Insurance companies are more standard users of financial information. They get the annual audited financial statements. They are mainly interested in the financial strength of the company, and financial information may affect our rates.

Vendors also want our financial statements, but we only provide them to our most important vendors.

Use of GAAP

(See External Financial Statements above).

Debt Covenants

Our compliance checklist is more than 20 pages. However, typical debt covenant calculations include:

- Attainment of defined EBITDA on a rolling 12-month basis – typically a minimum ratio of EBITDA to interest expense,
- Limitation on EBITDA-to-total debt ratios,
- Quarterly financial reporting compared to the prior periods, and
- Annual limits on capital expenditures.

Additionally, for working capital facilities, a borrowing base is calculated that determines how much can be borrowed based upon the amount of eligible receivables and eligible inventories.

Use of Fair Value

The only times we use fair value accounting is to compute future liabilities for other post-employment benefits and retiree medical expenses. Other than that, no one has asked for fair value accounting.

Internal Controls

We have worked hard on developing and maintaining internal controls, and we have documented our controls, although to a lesser degree than one would find in a public company. Due to the size of our business, and the fact that we are not public, we are able to observe the controls in effect every day, and we do not spend the time, or the money, to document independent testing of the operation of the various controls.

Company F

Company F is a small manufacturer owned by three partners who hope to take it public.

Company F has a total of 310 employees. There are five directors on its board, including the three current owners and two former owners. The CFO is one of the three current owners and the only director with financial expertise.

The CFO was interviewed for this report.

Internal Financial Statements

Internal financial statements are shared to varying degrees with the management team. Internal financials are provided in different formats to those people responsible for the various divisions. These are not full disclosure financial statements and are not based on GAAP since they exclude items that do not have an effect on current cash flows.

Those responsible for operations are provided with their operating numbers on a weekly and monthly basis. Weekly operating numbers include information on cash receipts, indirect costs, inventory levels and payroll and other human resource data such as overtime and double-time. Monthly operating data includes month and year-to-date profit and loss, forecast-to-actual comparisons, ratio analysis and other operating metrics for each profit center.

External Financial Statements

Our bank wants annual audited financial statements prepared in accordance with GAAP. It also wants monthly financial statements prepared consistently with the audited annual financial statements.

The bank also asks for:

- Detailed aged payables and receivables and inventory;
- Monthly loan covenant calculations, which include debt-to-tangible-net-worth and current ratio calculations;
- Collateral reports, with a breakdown of payables and receivables used in the calculations; and
- Quarterly cash flow coverage.

The bank takes this financial information and loads it into its computer database to calculate their loan ratios. The bank can get some additional information from the footnotes, such as depreciation and amortization, but it gets most of its information from the financial statements.

Leasing companies just want to make sure that we are liquid so that we can meet current obligations. The leasing companies get audited financial statements, and they read the footnotes.

A lot of our vendors have asked for our financial statements. However, we do not want to give our financial statements to vendors. Instead, I have calculated an "Altman Z score" for our company. An Altman Z score is a metric calculated by a computer model based on a company's financial information. It indicates the likelihood of a company going bankrupt. I then had our CPA firm verify and attest to it.

So I tell our vendors, “I won’t give you financial information, but I will give you our Z score based on our financials.”

I came up with this tool because we received a questionnaire from a big supplier, and we had to give them something.

Use of GAAP

We only do certain calculations, such as FIN 46, on an annual basis. FIN 46 is worthless to our organization, because we are not trying to hide anything in special purpose entities.

FIN 46 makes us add our real estate holding company entities to our balance sheet and profit & loss statement.

For a number of years, we received a qualified audit opinion because of the way we treated goodwill. However, the bank had no problem with this after we explained it.

Much of GAAP does not apply to private companies, and many accounting standards are onerous. For example, FSP 150 was a problem because the three partners have buy/sell agreements with the company that may have to be classified as debt.

Debt Covenants

In addition to collateral summaries and detailed profit & loss statements and balance sheets, we provide the following covenant calculations to our commercial bank:

- Tangible net worth;
- Debt to tangible net worth; and
- Cash flow coverage.

We prepare our internal interim financial statements based on what we define as modified GAAP, so there are minimal adjustments to get to GAAP at year end. For example, we do not include special purpose entities results in our monthly totals (FIN 46R requirement). We also have a provision for income taxes in the monthly financial statements that is reversed at year end so that we can target our distributions for taxes. Since our entity is an S Corporation, we do not pay taxes at the corporate level.

Use of Fair Value

Banks don’t look for fair value information. Periodically, our bank will request an appraisal for assets being used for collateral.

Internal Controls

Neither the bank nor the leasing companies have ever mentioned Sarbanes-Oxley. I have met with venture capital firms over the past six months, and they have never mentioned Sarbanes-Oxley. So we don’t see a potential reduction in our cost of capital from voluntary compliance with Sarbanes-Oxley.

However, we are QS 9000 and ISO 9000 [the International Organization for Standardization standard for quality management] certified, so people know that we have a lot of controls in place with regard to operations.

Clearly, if we were being purchased by a public company, they would want to know how we would plan to comply with Sarbanes-Oxley, but we haven’t yet addressed compliance.

Company G

Company G is a mid-size restaurant chain owned by a group of stockholders. There are no plans to go public.

Company G has about 11,500 team members. There are four directors on the board, including two shareholders, the internal general counsel and the outside counsel. The Chairman and CEO, one of the two shareholders on the board, is the only director with financial expertise.

The CFO was interviewed for this report.

Internal Financial Statements

Our information needs are really at two levels – internal and external. For us, the most important need for financial information is for internal purposes, so that we have good information for running the business. Internally, we generate an operations P&L that isn't pure GAAP to avoid some distortions at the business level. We roll that up into a GAAP-basis summary P&L for top management reporting. For our shareholders, the audited financial statements add little value to our internal reporting.

External Financial Statements

Our bankers like to see our audited GAAP financial statements for consistency and accuracy, but they concentrate on the cash flow being generated and fixed cost coverage. They ignore or add back what they call “funny money” items like minimum pension liabilities that have no immediate effect on cash flow. Insurance companies ask for audited financials as part of underwriting renewals and to ascertain our short- and immediate-term credit worthiness for open insurance claims reserves outstanding. They also mostly ignore the non-cash items.

Use of GAAP

GAAP is used to compare our financial statements to those of other companies in our industry and at least have a basis for good comparison. Most of our outside users adjust cash flows for any distortions caused by GAAP.

Debt Covenants

Our bankers use audited GAAP financial statements as a starting point and then adjust them for any one-time or unusual transactions or new GAAP statements that may affect comparability or have no effect on cash flow. Their goal, as I understand it, is to get to true cash flow being generated by the company vs. debt service requirements. The minimum pension equity adjustment is a perfect example of an item that is adjusted out of GAAP for their analysis purposes and our debt covenants.

Beyond the adjustment mentioned above, the covenants concentrate on fairly standard fixed cost coverage ratios (basically free cash flows generated vs. minimum debt and interest costs) as well as overall leverage with debt vs. equity (adjusted as per above).

Use of Fair Value

Fair value is not that meaningful unless at the time of buying or selling a business. There are practical problems in determining market values for all assets and liabilities. There is little use in re-determining fair market value for an asset each year if one plans to hold and use it for many years (i.e., buildings and equipment used in operations). Fair market value may be useful only for non-operating or to-be-disposed-of assets where a write-down may be needed.

Bank A

Bank A is a small regional bank based in the Southeast.

The Executive Vice President, Chief Credit Officer was interviewed for this report.

Required Financial Information

Virtually all of our customers on the commercial side are private companies.

Bank policy calls for full financial statement audits on total credit exposures of \$3 million or more. Reviews are acceptable for companies with credit exposures of \$3 million or less. For a company with at least \$10 million in annual revenues, we look for a full audit. This requirement is not cast in concrete, but it is our preference. We will make exceptions to this policy if we have known the borrower for a long period of time and the borrower has strong financial performance.

The financial information that we require is specified in the loan agreement. We look for liquidity, which can be shown on the balance sheet or the cash flow statement.

Requested Financial Information

On case-by-case basis, more detailed financial information is requested, depending on the industry or type of risk. If the loan is based on receivables, we may look at the aging reports that may not be disclosed in the financial statements.

Use of GAAP

We will often use tax returns to confirm certain information that we will not see from looking at GAAP statements alone. Tax returns become another level of verification or assurance, like audited financial statements.

Debt Covenants

We do not have standard loan covenants for our borrowers. However, for a loan with a repayment term over one year, we typically ask for minimum tangible net worth, which excludes intangibles, such as goodwill. In some instances, covenants may call for a target tangible net worth, with minimum net dollar requirements.

We ask for the ratio of debt to net worth. Debt is defined as total liabilities and could exclude trade payables, depending on the company's industry. An acceptable ratio of debt to net worth will also depend on each industry.

We also look for minimum debt service coverage, which is defined as the ratio of net income plus non cash charges to current maturities of long-term debt plus interest expense.

Use of Fair Value

Fair value is used outside of financial statements. Fair value is used for real estate loans.

Internal Controls

We want good internal controls. Compliance with Sarbanes-Oxley may give us more comfort, because compliance should lower the incidence of fraud and malfeasance.

Bank B

Bank B is a large New York City money center bank.

A First Vice President in its commercial banking group was interviewed for this report.

Required Financial Information

Our baseline requirements are:

- First, annual audited financial statements. We don't have a lot of small business clients, so most of our clients provide audited financial statements.
- Second, we require quarterly financial statements, which include the balance sheet, income statement and statement of cash flows, without footnotes. Depreciation and amortization provide important information. If we don't get a cash flow statement, we ask for a total for non-cash expenses.
- Finally, we require monthly financial statements, including the balance sheet, income statement and statement of cash flows. We also ask for more detailed information, such as accounts receivables, inventories and accounts payables.

All of this is specified in the original loan proposal, which is negotiated at the time the loan agreement is signed. Most companies can provide all of this information without a lot of extra work. We look for the same information from private companies as we do from public companies.

Audited financial statements provide comparability, consistency and accuracy. Footnotes are important. We believe that the better the footnotes, the better the information. Much of our analysis is cash flow related.

We usually want audited financial statements. But for smaller companies, we will accept a review rather than an audit.

Requested Financial Information

The norm is "we need more information." We ask for more detailed information on a case-by-case basis.

Use of GAAP

On a case-by-case basis, we will make exceptions to the information that is required by GAAP. We will usually make exceptions for accounting for non-cash items, as long as we can measure cash flow. For example, a retailer may not want to account for long-term leases with options, because GAAP requires you to calculate the average annual lease expense for a 20 year lease with options. This is all part of the loan negotiation.

However, it is important who the client's auditor is. We like the clients to use auditors who we know, which is important for large loans. The auditors that we know have the expertise to catch red flags that we might not otherwise catch.

We are sensitive to the costs of preparing financial statements under GAAP and the costs of auditing those financial statements.

However, we consider audited GAAP financial statements a standard management tool that should already be used to manage the business.

Debt Covenants

We really don't have a policy on debt covenants. They are very much tailored to the individual company and industry. However, we do have some "rules of thumb." For example, most banks look at leverage and earnings or cash flow.

A ratio of leverage is liabilities divided by tangible net worth. Tangible net worth does not include intangible assets such as goodwill. This ratio should be less than three to one.

A ratio of earnings or cash flow is funded debt (anything on which you pay interest) divided by EBITDA. This ratio should be less than three to one. EBITDA is very important to banks, because it is a proxy for cash earnings and therefore cash flow.

Use of Fair Value

If we are looking at equipment or real estate, we ask for appraisals. For equipment, there are several different possible valuations, including liquidation value (both orderly and forced), for sale value and fair market value.

We prefer conservative appraisals, such as forced liquidation value, because we have to worry about worst-case scenarios. This is the "second way out."

Internal Controls

A large percentage of Sarbanes-Oxley is not relevant to our needs.

We assume that our clients prepare proper financial statements. So, short of any real concerns, we do not ask for compliance with Sarbanes-Oxley. But at that point, we would already be looking to get out of the loan.

There is no benefit to offer better terms to private companies for compliance with Sarbanes-Oxley. We lend on cash flow, not internal control.

Bank C

Bank C is a small regional bank based in the Midwest.

The Loan Review Officer was interviewed for this report.

Required Financial Information

We use financial statements to assess the current and historical financial performance of the company and to determine its ability to repay the loan with cash generated from operations. The financial statement must give insight as to the current financial condition and historic trends regarding the company's current and capital positions. Also, the financial statements are important in determining the value of assets pledged as collateral to support the loan.

A full set of financial statements are required, including footnotes. The financial strength of the debtor is a driving factor as to how frequently we would require financial information. At a minimum, all borrowers are required to provide annual financial information for analysis purposes. More frequent financial information may be requested if the debtor is deemed to be a higher risk customer.

Requested Financial Information

The bank generally requests three years of complete financial statements. Quarterly and even monthly statements may be requested from higher risk customers.

Accounts receivable aging, accounts payable aging and equipment lists may also be requested if applicable.

Use of GAAP

GAAP financial statements provide uniformity in reporting financial information to allow for more accurate historic and industry comparisons. GAAP gives us greater confidence in the accuracy of the information provided.

Debt Covenants

Our loan covenants are not standardized, but instead depend on the borrower's industry. Generally, however, cash flow coverage, which is the ratio of cash flow from operations to current debt maturities, is a commonly used covenant. Most lenders want to see a ratio of 1.25 times current maturities.

Use of Fair Value

It would be unusual for us to require an independent asset valuation other than appraisals on real estate.

Bank D

Bank D is a large regional bank based in the Southeast.

The Senior Vice President, Credit Review Manager was interviewed for this report.

Required Financial Information

For nonpublic companies, we request audited and unaudited financial information, depending on the total credit risk of the borrower. The larger the deal, the more information required.

This would include a couple of years of annual financial information, quarterly financial information subsequent to the year in which we are making loan (including the balance sheet and profit & loss). We ask borrowers for information similar to the footnotes in audited financial statements.

Similar to any public company, we need the information to understand the company's business operations. We need good financial statements for proper cash flow analysis.

Many of our customers don't have audited financial statements. Sometimes their financial information is just compiled or reviewed, and sometimes it is self-prepared.

We require audited financial statements for loan balances over \$5 million, but we can make exceptions. However, the cost of an audit doesn't make sense for \$300,000 loan. This limit is typical based on my experience.

Requested Financial Information

Information that is either required on a routine basis or requested on an ad hoc basis depends on the size and type of loan. Our financial information requirements are on a sliding scale. Smaller loans are treated like credit card debt. For these loans, key financial info and individual credit scores are reviewed.

For larger loans, just the balance sheet and income statements are not enough—large loans require detailed granular information. We look for supporting schedules. We want to determine the quality of revenues and whether the business is cyclical.

For companies with asset-based loans, we review monthly financial statements to determine how accounts receivable and inventory balances change. This helps us understand the categories of operating cash flow and the repayment ability of the borrower. A loan officer may also discuss the financial statements with the borrower. Though monthly information may be requested, it could be onerous on the borrower, so unless it is needed it is normally not requested.

Use of GAAP

The annual audit provides a third-party review. An audit provides more detail, and is therefore better, than a review. GAAP requirements that need to be disclosed are disclosed.

Audited financial statements provide better quality of data and therefore more credible financial information. You assume compliance with GAAP when you get audited financial statements.

GAAP provides consistency. Banks can then compare the borrower's financial statements with those of other companies in the same industry.

Use of Fair Value

For real estate loans, per the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), you need an appraisal if you are lending against a property.

Internal Controls

For public companies, we look for compliance, to show that internal controls are in place. For private companies, we look informally to ensure the borrower's internal controls are sound.

For large, high risk loans, a group from the bank may conduct a field audit of the customer. This would be specified in the loan agreement.

Bank E

Bank E is a large international bank.

A director was interviewed for this report.

Required Financial Information

The most important thing to the lender is cash flow, which can be best determined from the cash flow statement and the income statement. The ultimate goal is to make sure you will get paid back.

The lender wants to see the historic volatility in cash flow. The lender wants to make sure a company can service debt, even in a down year.

The balance sheet is always important, because the lender wants to understand the borrower's existing obligations. The lender is not too concerned with assets.

In order of importance

1. The cash flow statement, income statement and EBITDA will help you determine whether you will get paid back.
2. The balance sheet will show existing obligations, both senior or subordinate to your debt.
3. The balance sheet will also show the hard asset base. If the borrower is not rated or non-investment grade, you want loan security with assets. To maximize repayment, you want to understand what's fixed and what's current. You can take security with intangibles, but you cannot derive value from them. Intangible assets of technology companies will show know-how and patents and may give you security, but have no real value. You can look at the loan to value ratio, which is really the loan amount divided by fixed assets.

Requested Financial Information

This depends on what type of company you are dealing with. If the borrower produces steel, you need to understand steel pricing and the customer base. This is hard to generalize. You want to understand the customer and supplier obligations, like contracts to buy steel from the producer and to sell to the customer at per ton and per dollar prices.

The Management's Discussion and Analysis (MD&A) is always valuable, because it explains why management does certain things. We actually require an MD&A on a quarterly basis and on a monthly basis, depending on the company. It explains what happened and predicts what may happen going forward. If you look at the financial statements, you could determine that margins were compressed by percentage, but the MD&A explains why the cost went up and led to compressed margin.

We usually ask a private company to provide an MD&A. For all non-investment grade borrowers, we require an MD&A when they deliver their quarterly financial statements. Monthly, we ask for an MD&A as a narrative, but not too extensive.

Use of GAAP

We require audited GAAP financial statements, because they provide comfort. Bankers are not auditors, and they won't take time to check the accounting. Small companies are thinly staffed, and we need more comfort that the accounting is correct. We rely on the auditor to provide a better understanding of the company.

I was a former accountant. Being in banking, I agree that GAAP has become too complex and provides more information than the average investor needs.

Debt Covenants

For loan syndications, there are no "standard" bank debt covenants. It's what the bank syndication market is willing to accept. For a privately held company in the non-investment grade rating category, you typically have a coverage test (fixed charge or interest coverage), a leverage test (Total Debt/EBITDA, with adjustments from time to time) and a Maximum Capital Expenditure test.

The exact level of the ratio for the coverage and leverage tests depends on the financial projections the company provides. If a company is paying off debt over time, then we'll set a leverage covenant that steps down over time. For example, the ratio could go from 4.0 times Debt/EBITDA to possibly 3.0 times Debt/EBITDA, in increments of 0.25, depending on how quickly a company delivers.

All this information is gathered from the company's projections to create the covenants. Then, on an on-going basis, the company must provide a "compliance certificate" on a quarterly basis, which shows the actual calculations. They do this at the same time that they deliver their financial information to the bank group, in accordance with the loan agreement.

Use of Fair Value

Fair value information would be helpful, but you typically have your own appraisals done. You have to consider the lender's mind set. Book value is typically under market value. Though appraisals do help, they do not tell you what something could be sold for if the company goes under in two years. It depends on what you're doing with the company in terms of loaning money.

You need both historical cost and fair value. It is nice to have both because you look at both the upside and the downside. Most likely, I don't make the decision to loan money. I try to get the credit officer to do that. They will ask for things, because they have to look at downside. They want to see the minimum value of the assets.

Loan officers work with us throughout whole process. If we loan money to the company, the company will give us projections. We would have a different view based on our knowledge of other companies. We develop different models, taking into consideration different economic and political factors. I might be more optimistic on pricing on commodities. Loan officers are more bearish. Together, we come up with the pricing.

Internal Controls

Most people think that Sarbanes-Oxley has gone too far. Users think that it provides useless information to a certain degree. From the lender perspective, the loan is based on a credit agreement. If there are issues or weaknesses in internal controls, you will find them during due diligence. But the credit agreement will be structured to mitigate against risk.

Bank F

Bank F is based in New Mexico.

Required Financial Information

Financial statements and other information needed to make an informed decision as well as monitor ongoing trends are required and requested. We require specific financials relevant to the credit being granted. Therefore, we typically don't ask for what we don't need.

Requested Financial Information

We rely on financial statements of privately held companies as a very important and major part of making loan decisions. Accuracy is the most important factor. We typically ask for a balance sheet, an income statement and a cash flow statement, as well as pro forma statements and budgets. For most deals, financial information is required annually. For more complex or risky situations it could be required quarterly or even monthly.

Use of GAAP

Loan type, size and complexity determine whether or not financial statements are prepared and audited in accordance with GAAP. For small companies, we will accept self-prepared financials. For those companies that provide GAAP financials, this provides more consistency and assurance that specific standards are being followed and met. Once received, GAAP numeric information is entered into cash flow analysis programs for additional review.

Use of Fair Value

Independent asset valuations can be very beneficial especially when a borrower has assets from outside any lending area.

Bank G

Bank G is a community bank based in Virginia.

Required Financial Information

We generally have to request documents from each borrower. However, loan agreements generally require a company to provide annually a balance sheet, income statement and statement of cash flows as of its fiscal year end.

Requested Financial Information

Requests vary on overall risk and depend upon several factors, including:

- Total bank obligations,
- Source or repayment,
- Collateral quality, and
- Liquidity, etc.

This information is needed to determine capital and liquidity position and debt service capacity from a historical and pro forma basis.

Based on these criteria, we receive balance sheets that could range from those that are prepared in-house to those that are audited by a certified public accountant (CPA). Income statements that are prepared in-house are verified against the company's federal tax return prepared by a CPA and filed with the Internal Revenue Service. Additionally, for principals of a closely held private company, we generally request and require copies of personal financial statements and individual tax returns.

All of this information is generally requested for three years for new loans and on an annual basis thereafter. In limited cases we may require construction in progress, accounts receivable and inventory aging reports, sometimes on a quarterly basis.

Use of GAAP

We have more confidence in financial statements prepared by a CPA in accordance with GAAP. Specifically, GAAP statements generally contain considerably more detail including notes to the statement and always include the current and future maturity of long term debt.

Quality and timeliness of financial statements should not be sacrificed in instances when credit risk requires GAAP audited reporting. However, this should not cause a private company unnecessary expense.

Use of Fair Value

In some cases an independent asset valuation may be beneficial to making a credit decision. When this is requested we prefer obtaining a liquidation value and a fair market value.

Bank H

Bank H is a bank based in North Carolina that focuses on small business lending.

Required Financial Information

We are cash flow lenders that use information to determine a borrower's historical cash flows, financial strength and ability to repay loans. Size of total loan relationship is our determining factor as to sophistication of the financial statements requested. Companies that are larger or borrow more frequently provide more detailed information.

Requested Financial Information

We typically ask for:

- Lists of assets and liabilities,
- Profit and loss statements,
- Cash flow statements, and
- Tax returns and other proof of income.

Tax returns and financial statements are typically required annually—more often if warranted. If a company is financing its accounts receivable, then monthly or quarterly information is expected. If we have audited statements, we have less of a need for tax returns.

Use of GAAP

Both GAAP and IRS information represents historical data to us and are important for our decision-making. GAAP primarily reassures us that data is accurate and of a borrower's ability to continue as a going concern.

Use of Fair Value

Little value will be placed on independent asset valuation for most of our customers. Fair value should be nothing more than a separate supporting schedule or footnote.

Bank I

Bank I is based in Wisconsin.

Required Financial Information

We need to be able to determine the financial strength of the company from a variety of perspectives. More specifically, we are looking to determine a company's:

- Viability as it relates to its current net worth;
- Ability to generate future earnings;
- Asset base, including the quality and availability of that base as collateral to support lending;
- Cash flow and ability to generate future cash flow; and
- Obligations to others and the effect of those obligations on any obligation it may have with us.

Specific information that we are looking for includes the balance sheet, income and cash flow statements and wherever possible, tax returns. In addition, because of the nature of ownership of many small businesses, we frequently look to personal statements and the potential of personal guarantees to further support borrowing needs. For startup businesses we will also require a business plan with forward looking projections.

Requirements may differ based more on the risk, rather than the size, of the loan. For example, we have smaller credits for which we prefer to see independently-prepared financial statements and larger credits where self-preparation is satisfactory.

Tax reports, individual financial statements and even cash flow statements are usually only provided annually. Factors that enter into deciding the frequency of the income statement and balance sheet reporting, whether monthly, quarterly or annually, will include conclusions based on the perceived strength of the business, the relative risk inherent in the type of business, the practicality and availability of the information and the length of time of the relationship with the customer. Whenever we receive the financial statements we enter them into our "Statement Spreading" software to prepare us for periodic loan review - which is required by policy based on size or random sample or for consideration when new terms or loan amounts are under consideration.

Requested Financial Information

We typically only get what we ask for and only ask for what we need. Virtually all of our clients are privately held companies. With a few exceptions, these clients do not have internal audit procedures, or external audited statements. For private status borrowers we may be satisfied with a self-prepared statement.

Use of GAAP

GAAP means something different to us as preparers of financial statements than as users of financial statements. Our own business has a greater need for strict compliance to both GAAP and regulatory requirements vs. the businesses with whom we work. Generally speaking these businesses are non-complex entities where financial record keeping and reporting is relatively easy and consistently understood and applied. Nonetheless, we do have an expectation that statements we receive are accurate and that they properly represent the financial status of the business. Whenever we have concerns that a business needs to improve its financial reporting, we request or even require that business enhance their processes or submit audited financial statements.

For those companies that do submit audited financial statements, one of the primary advantages we see is that the business must pass a higher level of scrutiny in its reporting process. Where there is an attestation, we assume that the financial statements are more likely to be prepared in a manner consistent with GAAP.

The significant costs of compliance with GAAP can be a deterrent to companies. As a creditor we have to weigh the relative benefits of requiring this level of reporting compared to the benefit we may determine for the company to do so. All the factors mentioned and others affect our decision whether we will require this level of compliance.

Regardless, we find that we make better lending decisions when we have some understanding of the business venture, when we have knowledge of the principals involved and their personal history and when we have a comfort with their business plan. We still rely heavily on collateral and cash flow.

Use of Fair Value

If a client has independent asset valuations we are interested in them.

Investment Bank A

Investment Bank A is a small regional investment banking firm.

The principal was interviewed for this report. Prior to founding this investment bank, she spent 18 years as a certified public accountant with a Big Four public accounting firm, including several years as an audit partner. She later headed the firm's merger & acquisition activities group.

Required Financial Information

We need and rely on GAAP financials. These financials need to be attested to.

We also look for supplemental information to the basic information. For example, we produce "owner neutralized" statements, in which we add back owner compensation.

We are interested in how much equity vs. debt the company has.

Buyers are interested in capital expenditure requirements. Many buyers pay on EBITDA less capital expenditures. They are interested in cash flow, which we can get from the financial statements. However, it is difficult to get normalized capital expenditures from the financial statements. This may involve playing catch up.

Requested Financial Information

Sometimes, we have to specifically request past year financial statements to identify trends, such as capital expenditures. In these cases, the sellers usually protest.

Use of GAAP

GAAP provides security. To us, GAAP means FASB standards. Many private companies cannot represent that their interim statements are GAAP, but disclose types of changes at year end to the buyer.

We have modest expectations for privately held companies to comply with publicly held company standards.

Use of Fair Value

Information on the fair market value of assets is particularly critical if the company is not liquid or does not have a lot of cash. So we are receptive to the notion of fair value. However, it is really hard to get reliable data.

In a liquidation scenario, we would request the same fair value information from appraisers that banks would ask for. This information is especially important for a weak company. It is not as important for a strong company.

Investment Bank B

Investment Bank B is a small regional investment banking firm.

One of the partners was interviewed for this report. Prior to founding this firm, he had been an analyst at a major New York City brokerage and a consultant for a major consulting firm.

Required Financial Information

We look at the financial statements to ensure that we understand the performance of the company. We need accuracy in the financial statements, and we prefer them to be prepared in accordance with GAAP, which provides consistent measurement tools. GAAP is not always logical, but accuracy and consistency is important. In an ideal world, GAAP would reflect actual business realities.

In our line of work, we prefer that private companies be seen in the same light as public companies, so we like the financial statements of private companies to be prepared using the same GAAP used by public companies.

The sooner that private companies can prepare financial statements in the same way as public companies, the better. Restating financials can take longer.

Use of GAAP

We define GAAP as FASB defines GAAP, even though there may be different needs for financial information from publicly traded companies vs. privately held companies.

The real advantage of GAAP for public companies is that quarterly financial information provides an immediate focus on short-term results. Near-term reporting is not as important for private companies. Information on investment performance (such as for loan covenants) may be based on annual numbers, and there is not as much focus on quarterly information.

For smaller companies, we do not necessarily require audited financial statements, but they must comply with GAAP. We also like supplemental schedules, because GAAP financial statements do not provide the details of revenue and expense items. We use GAAP financial statements as a starting point.

Use of Fair Value

Our company does do valuation work, but not that frequently.

I don't think any financial statement can give you good fair value on a private company. There is not one generally accepted way to value a company's assets. For example, based on cash flow, the fair value of a media business is different from that of a chemical company.

Internal Controls

A company may not necessarily get better terms, but compliance with Sarbanes-Oxley makes closing easier. Otherwise, the transaction might drag out.

Appendix – Financial Statement Requirements for Commercial Borrowers

The following is an exhibit prepared based on one of the banks interviewed for this report.

Business loans booked in the commercial, international, private banking, private client services and corporate and investment banking portfolios should be supported by the most current three fiscal years of year-end financial statements for the borrowing entity and all business guarantors. The requirements for business financial statements and personal financial statements satisfactory to the bank are described in the next section.

Business Financial Statements

Business financial statements are required for all loans to commercial entities and entities that act as guarantors. To be considered satisfactory to the bank, interim business financial statements must include a current fiscal year balance sheet and income statement.

Personal Financial Statements

Personal financial statements are required for all loans to individuals and for individuals who act as guarantors. To be considered satisfactory to the Bank, the individual borrower or guarantor must submit a current personal financial statement, a current tax return with all schedules, or a current fiscal-year balance sheet and income statement. When the balance sheet and income statement are provided and relied upon, note that the attestation statement must be signed. Additionally, certain guidelines apply to the financial analysis of personal financial statements.

Financial Statement Dates

Credit decisions should be based on the most current information possible. Therefore, current financial statements will be required at the time of a loan request. To be considered current, the most recent business and personal financial statements in the credit file are not to be more than 17 months old, which allows a 150-day window of time for the business borrower to submit new annual financial statements.

Frequency of Financial Statements

Annual updates should be provided promptly so that credit decisions are based on current information, preferably no more than five months old. If older than five months, interim financial statements are required for a renewal or a new credit.

Interim statements are recommended to monitor the financial performance and condition of all borrowers. The greater the credit risk, the higher the frequency of interims. Monthly, quarterly and semi-annual statements are the most common frequencies. The frequency requirement is set as a financial covenant and usually cannot be changed until there is an opportunity to renegotiate the terms of the credit facilities.

Statement Types

Business financial statements can be generated internally by the borrower or prepared externally by third parties. The Bank generally prefers externally prepared financial statements for the objectivity and scrutiny that third party preparers may be able to impart to the effort. However, there is a wide range of quality available in the market for externally prepared financial statements.

First, the third party preparers may range from bookkeeping services to major accounting firms. Within these organizations, the preparer may not be a CPA, may lack auditing experience, may not have general or specialized accounting background, and may not have any experience with the borrower's line of business.

Second, the third party preparer offers two types of financial statement scrutiny – audited or unaudited. Unaudited financials come in two versions, compilation and review. The review includes footnotes, but otherwise, they are unaudited financials. Accountants sometimes prepare a company's tax returns and then package them as compilations or reviews. Tax-return financial statements are often prepared on a cash-basis or tax-basis accounting method instead of according to GAAP.

In contrast, audited financials have been prepared after a physical audit of assets and liabilities. In theory, audits have four types of possible opinions—unqualified, qualified, disclaimer or adverse. The unqualified or “clean” opinion is most desirable because the CPA firm is certifying that the financials have been prepared in accordance with GAAP. A qualified opinion means some item was not audited or there is an unresolved issue preventing a clean opinion.

A disclaimer occurs when the accountant does not have enough information to render an opinion. The adverse opinion is used when the financials are not prepared according to GAAP. In practice, most firms expect to receive an unqualified opinion, and in fact, most do.

It is desirable to have audited statements bearing the unqualified opinion of a certified public accountant on all extensions of credit. However, because of the relative difficulty and expense in obtaining audited statements, thresholds were set based on the following statement types:

- Internally prepared statements, tax returns and compilations,
- Review statements, and
- Audited statements.

The balance sheets in personal financial statements are typically prepared by the borrower or guarantor. Outside preparation is more common for personal tax returns, but the outside preparer of personal financial statements does not usually audit or render an opinion on them. Because personal balance sheets are prepared with market values, they are not usually issued with an unqualified opinion.

Internally Prepared Statements, Tax Returns, or Compilations

Annual internally prepared statements, tax returns, or compiled statements are acceptable on borrowers with total borrower exposure of \$1 million or less.

Reviews

Annual review statements are required for borrowers with total borrower exposure of more than \$1 million but less than \$5 million. These statements are also acceptable on any agriculture credit with an exposure up to \$20 million.

Audited Statements

Audited financial statements are required for borrowers with total borrower exposure of \$5 million or more. These statements are also required on any agriculture credit with an exposure of \$20 million or more.

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Financial Executives Research Foundation, Inc, would like to thank and acknowledge the NFIB Research Foundation for their generosity and support in underwriting this report.

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International Standard Book Number 1-933130-26-1

Printed in the United States of America

First Printing

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