

Accounting for Success

Beyond the Ratios: Why a Borrower's Internal Controls Are a Banker's Best Friend



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A borrower's application lands on your desk. The balance sheet is solid, the debt-to-equity ratio is healthy, and the income statement shows strong profits. On paper, it's perfect. Loan approved!

Six months later, the borrower defaults. Turns out, their trusted bookkeeper was paying fictitious vendors for inventory that didn't exist. That same non-existent inventory was used to secure your loan. The problem wasn't the business model. The fatal flaw was that the financial ratios you relied on were built on garbage, unreliable financial statements because of non-existent internal controls. No one had bothered to physically count the inventory and compared it to the general ledger.

Ratios Tell You What, Not How

As a banker, you are in the business of assessing risk. As auditors, we are in the business of verifying. A loan decision based purely on ratios makes a dangerous assumption: that the underlying data is accurate.

Ratios are highly valuable, but they are lagging indicators. They tell you what happened in the past, but they fail to reveal how those numbers were created or if they are reliable. The true story of risk is not in the final numbers; it's in the process that creates them.

What Are Internal Controls?

Internal controls are the checks and balances inside an organization designed to prevent (or quickly detect) costly errors and fraud.

Think of them like safety features in a car: seat belts, airbags, brakes. You can drive without them, but it's asking for trouble. Lending to a business with weak controls is like giving a loan to a driver with no brakes; the car looks great, but the risk? Huge.

In practice, controls are simple, common-sense procedures:

- **Segregation of Duties:** The person who approves a bill cannot be the same person who cuts the check and reconciles the bank account. This single control prevents the most common types of embezzlement.
- **Physical Controls:** Is the valuable inventory in a locked warehouse, or is it sitting in an open yard? Are the blank check-stocks locked in a cabinet, or are they sitting on the bookkeeper's desk? Does the company keep perpetual inventory records? Having physical controls over valuable assets is key to preventing losses.
- **Reconciliations:** Is someone actually reconciling the bank statement to the general ledger every single month? Is the inventory sub-ledger regularly matched against what's physically on the shelf? This simple act proves the books are correct.
- **Analytical Review:** One of the most powerful, yet often overlooked, controls that an organization can implement is the simple act of management actually reading their financial results on an ongoing basis, not just filing them away. A strong manager that regularly reviews monthly income statements, comparing actual results to budget and prior periods can quickly spot anomalies—whether it's fraudulent spending or emerging business trends—before they escalate into serious issues like default.

Three Red Flags You Can Spot Easily

The next time you're in a meeting or on a site visit, use these simple techniques to uncover weaknesses in internal control.

- **The "Key Person" Risk:** Ask the owner: "What would happen if your bookkeeper won the lottery and didn't come in tomorrow?"

If the owner laughs and says, "I'd be in trouble for a week, but we'd manage," that is a sign. It implies processes are documented and others can step in. But if the owner's face goes pale and they say, "We would be ruined. I have no idea how our books even work," you have identified a massive control weakness. It means one person has all the keys to the kingdom, and no one is checking their work.

- **The Disorganized Site Visit:** On your next site visit, look beyond the new equipment you are financing. Is the office buried in old paperwork? Is the warehouse a mess? Is the inventory area chaotic and disorganized? A chaotic physical environment almost always mirrors a chaotic back-office. It is a visible sign that management is not focused on process, precision, or the protection of its assets. This Disorganization is a breeding ground for errors, waste, and fraud.

- **Management Letters: The Most Important Document You're Not Asking For.** The management letter is where the real risk is detailed. This is the most valuable takeaway I can give you.

While our final audit opinion on the financial statements is often "clean, we are also required to share significant weaknesses we identified in financial reporting controls to the client's governance in separate, private "management letters."

These letters might say, "The same person who collects checks also prepares the bank deposit and records the revenue," or "We noted there is no formal review of employee expense reports." Ask for the management letter for your loan file. If the company will not share it, that's a red flag. A transparent client who provides it and can speak to how they are fixing the issues is a client who is actively managing their risk.

Lend to the Process, Not Just the Ratios

A good loan isn't just about good numbers; it's about a well-managed business that protects its assets and ensures its reports are accurate by maintaining strong, simple controls.

The next time you review a loan application, look past the finished ratios. Ask the owner how bills are paid and who reconciles the bank account. Most importantly, ask for their auditor's management letter as it could be the most revealing document you read all day.