THE ABC'S OF BORROWING

All businesses, no matter what size, need to raise money at some time. Small business owners may be able to dip into their personal savings or borrow money from friends. More likely, they'll have to look to outside sources for financing.

Is Your Firm Credit Worthy?

Getting money when you need it is as necessary to the operation of your business as a good location or an adequate labor force. Before a bank will lend you money, the loan officer must be satisfied with the answers to these questions:

- What is your character; will you *want* to repay the loan? How capable are you in managing the business;
- Will you be *able* to repay the loan?
- Do you have a financial plan and forecast showing why you need the loan and how you will repay it?
- What is the specific purpose of the loan? Is it a short- or long-term need?
- Is the loan large enough to cover a change in your situation, but not so large that its repayment will be a heavy burden?
- What is the current economic outlook for your business and industry?
- Do you have a reasonable amount at stake in the business?
- What collateral is available to secure the loan amount?

Financial Information Required by Lenders

The two basic financial documents that lenders require are the balance sheet and the income statement. The balance sheet is the major yardstick for solvency; the income statement is the common measure of profits. Using these and other sources, lenders ask the following questions.

General

1. Are the business's books and records up-to-date and in good condition?
2. Does the business have a lawyer and/or accountant?
3. Who are the customers; what percentage of total sales do the largest customers represent?
4. Are all obligations paid promptly?
5. What is the insurance coverage?

Accounts Receivable

1. What is the quality of the accounts receivable?
2. Have any been pledged to another creditor?
3. Are customers paying promptly?

4. Is there an allowance for bad debts?

Inventory

1. Can the merchandise be sold at full price?
2. How much raw material is on hand?
3. How much work is in progress?
4. How much of production is finished goods?
5. Is too much money tied up in inventory?
6. Is the inventory turnover in line with industry norms?

Fixed Assets and Equipment

1. What is the type, age and condition of the equipment?
2. What are the depreciation schedules?
3. What are the details of mortgages or leases?
4. What are the company's future fixed asset and equipment needs?

The lender scrutinizes the cash flow of the business to determine whether the owner-manager is providing sufficient cash to meet the firm's obligations. The lender also makes sure that cash needed for working capital is not being diverted to other areas (e.g., acquisition of fixed assets) thereby reducing liquidity.

Types of Loan

When you set out to borrow money for your firm, it is important to know the type of loan you need and its proposed duration. There are two basic kinds of loans (lines *of credit* and *installment loans)* and two general categories of loan length *(short-term* and *long-term)*. The purpose for which the funds are to be used is an important factor in deciding what kind of loan to request. There's also an important connection between the length of the loan and the source of repayment. Generally, short-term loans are repaid from the liquidation of current assets that are financed (i.e., receivables, inventory), while long-term loans are generally repaid from earnings. The following are short descriptions of common types of loans and loan durations.

Line of Credit An arrangement in which the bank disburses funds as they are needed up to a predetermined limit. The customer may borrow and repay repeatedly up to the limit within the approved time frame (usually one year).

Installment Loan An agreement to provide a lump sum of money at the beginning of the loan. The loan is paid back in equal amounts over a number of years.

Short-term Loan Can be used for purposes such as financing a seasonal buildup in accounts receivable or inventory. Lenders usually expect these loans to be repaid after their purposes have been served; for example, accounts receivable loans when the outstanding accounts have been paid by customers and inventory loans when inventory has been sold and cash collected. Short-term loans are generally repaid in less than a year.

Long-term Loan A formal agreement to provide funds for more than one year; most loans are for an improvement that will benefit the company and increase earnings. An example would be purchasing a new building that will increase capacity or a machine to make manufacturing more efficient. Long-term loans are usually repaid from profits.

Collateral

Sometimes your signature and general credit reputation are the only collateral the bank needs to make a loan. This type of loan is called *unsecured.* At other times, the bank requires a pledge of some or all of your assets as additional assurance that the loan will be repaid. This is called a *secured* loan. The kind and amount of collateral depends on the bank and on variables in the borrower's situation.

Many types of collateral can be pledged for a secured loan. The most common are endorser, warehouse receipts, floor planning, purchase money security interest (PMSI) in furniture and/or equipment, real estate, accounts receivable, inventory , savings accounts, life insurance policies, and stocks and bonds.

Endorser A borrower may ask another person to sign a note to augment the borrower credit. This endorser is then liable for the note: if the borrower fails to pay, the bank expects the endorser to pay. Sometimes the endorser may also be asked to pledge assets.

Co-maker This is when an endorser assumes an obligation jointly with the maker, or borrower.

In this arrangement, the bank can collect directly from either maker or co-maker

Guarantor An endorser guarantees payment of a note if the borrower does not pay. Lenders often require guarantees from officers of corporations in order to ensure continuity of effective management

Warehouse Receipt A bank may take commodities as collateral by lending money on a warehouse receipt. The receipt is usually delivered directly to the bank, and shows that the merchandise has either been placed in a public warehouse or left on your premises under the control of one of your bonded employees. Such loans are generally made on staple or standard merchandise that can be readily marketed. The typical loan is for a percentage of the cost of the merchandise.

Floor Planning Merchandise such as automobiles, appliances and boats must be displayed to be sold, but the only way many small marketers can afford displays is by borrowing money. Such loans are often secured by a note and trust receipt. The trust receipt is used for serial numbered merchandise. It acknowledges receipt of the merchandise, shows agreement to keep the merchandise in trust for the bank, and verifies the promise to pay the bank as the goods are sold.

Purchase Money Security Interest If you buy expensive equipment like a cash register or delivery truck; you may be able to get a loan using the equipment as collateral. This kind of loan is also called a *chattel mortgage.* The bank assesses the present and future market value of the equipment and makes sure it is adequately insured

Real Estate Real estate is another form of collateral and is usually for long-term loans. In evaluating a real estate mortgage, the bank considers the market and foreclosure value of the property and its insurance coverage.

Accts. Receivable Many banks lend money against accounts receivable, and count on your customers to pay your loan. The bank may take accounts receivable on a notification or non-notification plan. Under the notification plan, the purchaser of the goods is informed by the bank that the account has been assigned, and is asked to make payments directly to the bank. Under the non-notification plan, customers pay you and you pay the bank.

Inventory Merchandise, wares and any assets of a retail, wholesale, or manufacturing business that can be liquidated, can provide a form of financial guarantee against loan proceeds. Unless otherwise specified in the loan documents, plant and equipment (e.g., computers, cash registers, manufacturing equipment, telephones and other fixtures) can also be included as inventory to be held as collateral

Savings Accounts Certif. Of Deposit It is possible to get a loan by assigning a savings account or Certificate of Deposit to the bank. You assign the account and the bank keeps the passbook. If you assign an account at another bank as collateral, the lending bank asks the other bank to mark its records to show that the account is held as collateral.

Life Insurance Another kind of collateral is the cash value of a life insurance policy in which you assign the policy to the bank. Some people prefer to use life insurance as collateral rather than borrowing directly from the insurance company because a bank loan is generally easier to obtain and carries a lower interest rate.

Stocks and Bonds Marketable stocks and bonds are also sources of collateral. Banks usually lend 75% or less on the value of high-grade stocks and up to 90% on government securities. The limits leave a cushion or margin for protection against declines. If the market value of the collateral falls below a certain level, the bank may ask for additional collateral or a partial payment of the loan.

The Loan Application

Banks and other lending institutions, including the Small Business Administration (SBA), require a loan application on which you list information about your business. Before you fill out a loan application, you should talk with your accountant, banker or SBA representative to make sure that you are eligible for the type of loan for which you want to apply.

SBA Form 4 is an example of a loan application. It is more detailed than most bank forms because the bank usually has the advantage of prior knowledge of the applicant and his or her activities, while SBA usually does not. Also, the longer maturities offered on SBA loans ordinarily require more information about the applicant.

While most sections of a loan application are self-explanatory, some applicants have trouble with certain sections because they do not know where to get the information requested. The collateral section is an example. Collateral are the assets you are pledging to the lender to guarantee the loan. Your company's books should show the market value of assets such as business real estate and business machinery and equipment. *(Market value* means what you paid for such assets less depreciation.) If your records do not contain detailed information on these assets, the bank can sometimes get it from your federal income tax returns. Reviewing the depreciation that you have taken for tax purposes on such assets can help to ascertain their value.

If you are asked to fill out a Balance Sheet for your business, remember that you must show the condition of your business within 60 days of the date on your loan application. Also, if your records do not show the details necessary for working up income (profit and loss) statements, your federal income tax returns may be useful in getting together facts for a loan application.

The Loan Agreement

A loan agreement is a tailor-made document that states all of the terms and conditions of the loan. It gives the amount of the loan and terms of repayment, identifies the principle parties, and lists any restrictions placed on the borrower.

Limitations Banks often include limitations that restrict what an owner can do. These limitations depend to a great extent on the company. If the company is a good risk, the limitations will be minimal. On the other hand, a higher risk company will have greater limitations. The three principle limitations involve repayment terms, the use of collateral and periodic reporting. Limitations are spelled out in the *covenant* section.

Covenants *Negative covenants* are restrictions placed on the borrower by the lender. Some examples are limitations on the borrower's total debt, agreement not to pledge assets to other creditors, and limitations on the amount of dividends that may be issued.

Positive covenants are all actions to which the borrower must agree. They include maintaining a minimum working capital, carrying adequate insurance, adhering to the repayment schedules, and supplying the lender with regular financial statements and reports. Loan agreements can be amended and exceptions made. Certain provisions may be waived from year to year with the consent of the lender.

Negotiating With the Lender

Ask to see the papers before the loan closing; reputable lenders will be glad to comply. While you're mulling over the terms, you may want to get the advice of your associates and advisors. Discuss and negotiate the lending terms before you sign the loan agreement –it’s good practice, no matter how much you need the money. Chances are the lender may be willing to compromise on some of the terms; try to get terms with which you know your company can live. Remember, once the loan is made, you are bound by it.