ma 170

Management Aids for Small Manufacturers
U.S. Small Business Administration

The ABC's of Borrowing

Revised by Staff Members, Financial Assistance,
Small Business Administration, Washington, D.C.

Revised April 1977

Summary

Some small businesspersons cannot understand why a lending institution refuses to lend them money. Others have no trouble getting funds, but they are surprised to find strings attached to their loans. Such owner-managers fail to realize that banks and other lenders have to operate by certain principles just as do other types of business.

This Aid discusses the following fundamentals of borrowing: (1) credit worthiness, (2) kinds of loans, (3) amount of money needed, (4) collateral, (5) loan restrictions and limitations, (6) the loan application, and (7) standards which the lender uses to evaluate the application.

much raw material is on hand? How much work is in process? How much of the inventory is finished goods?

Is there any obsolete inventory? Has an excessive amount of inventory been consigned to customers? Is inventory turnover in line with the turnover for other businesses in the same industry? Or is money being tied up too long in inventory?

Fixed Assets: What is the type, age, and condition of the equipment? What are the depreciation policies? What are the details of mortgages or conditional sales contracts? What are the future acquisition plans?

What Kind of Money?

When you set out to borrow money for your firm, it is important to know the kind of money you need from a bank or other lending institution. There are three kinds of money: short-term money, term money, and equity capital.

Keep in mind that the purpose for which the funds are to be used is an important factor in deciding the kind of money needed. But even so, deciding what kind of money to use is not always easy. It is sometimes complicated by the fact that you may be using some of various kinds of money at the same time and for identical purposes.

Keep in mind that a very important distinction between the types of money is the source of repayment. Generally, short-term loans are repaid from the liquidation of current assets which they have financed. Long-term loans are usually repaid from earnings.

Short-Term Bank Loans

You can use short-term bank loans for purposes such as financing accounts receivable for, say, 30 to 60 days. Or you can use them for purposes that take longer to pay off—such as for building a seasonal inventory over a period of 5 to 6 months. Usually, lenders expect short-term loans to be repaid after their purposes have been served: for example, accounts receivable loans, when the outstanding accounts have been paid by the borrower's customers, and inventory loans, when the inventory has been converted into saleable merchandise.

Banks grant such money either on your general credit reputation with an unsecured loan or on a secured loan—against collateral.

The unsecured loan is the most frequently used form of bank credit for short-term purposes. You do not have to put up collateral because the bank relies on your credit reputation.

The secured loan involves a pledge of some or all of your assets. The bank requires security as a protection for its depositors against the risks that are involved even in business situations where the chances of success are good.

Term Borrowing

Term borrowing provides money you plan to pay back over a fairly long time. Some people break it down into two forms: (1) intermediate—loans longer than 1 year but less than 5 years, and (2) long-term—loans for more than 5 years.

However, for your purpose of matching the kind of money to the needs of your company, think of term borrowing as a kind of money which you probably will pay back in periodic installments from earnings.

Equity Capital

Some people confuse term borrowing and equity (or investment) capital. Yet there is a big difference. You don't have to repay equity money. It is money you get by selling a part interest in your business.

You take people into your company who are willing to risk their money in it. They are interested in potential income rather than in an immediate return on their investment.

How Much Money?

The amount of money you need to borrow depends on the purpose for which you need funds. Figuring the amount of money required for business construction, conversion, or expansion—term loans or equity capital—is relatively easy. Equipment manufacturers, architects, and builders will readily supply you with cost estimates. On the other hand, the amount of working capital you need depends upon the type of business you're in. While rule-of-thumb ratios may be helpful as a starting point, a detailed projection of sources and uses of funds over some future period of time—usually for 12 months—is a better approach. In this way, the characteristics of the particular situation can be taken into account. Such a projection is developed through the combination of a predicted budget and a cash forecast.

The budget is based on recent operating experience plus your best judgment of performance during the coming period. The cash mortgage, the bank finds out: (1) the location of the real estate, (2) its physical condition, (3) its foreclosure value, and (4) the amount of insurance carried on the property.

Accounts Receivable

Many banks lend money on accounts receivable. In effect, you are counting on your customers to pay your note.

The bank may take accounts receivable on a notification or a nonnotification plan. Under the **notification** plan, the purchaser of the goods is informed by the bank that his account has been assigned to it and he is asked to pay the bank. Under the **nonnotification** plan, the borrower's customers continue to pay him the sums due on their accounts and he pays the bank.

Savings Accounts

Sometimes, you might get a loan by assigning to the bank a savings account. In such cases, the bank gets an assignment from you and keeps your passbook. If you assign an account in 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 life insurance. Banks will lend up to the cash value of a life insurance policy. You have to assign the policy to the bank.

If the policy is on the life of an executive of a small corporation, corporate resolutions must be made authorizing the assignment. Most insurance companies allow you to sign the policy back to the original beneficiary when the assignment to the bank ends.

Some people like to use life insurance as collateral rather than borrow directly from insurance companies. One reason is that a bank loan is often more convenient to obtain and usually may be obtained at a lower interest rate.

Stocks and Bonds

If you use stocks and bonds as collateral, they must be marketable. As a protection against market declines and possible expenses of liquidation, banks usually lend no more than 75 percent of the market value of high grade stock. On Federal Government or municipal bonds, they may be willing to lend 90 percent or more of their market value.

The bank may ask the borrower for additional security or payment whenever the market value of the stocks or bonds drops below the bank's required margin.

What Are the Lender's Rules?

Lending institutions are not just interested in loan repayments. They are also interested in borrowers with healthy profit-making businesses. Therefore, whether or not collateral is required for a loan, they set loan limitations and restrictions to protect themselves against unnecessary risk and at the same time against poor management practices by their borrowers. Often some owner-managers consider loan limitations a burden.

Yet others feel that such limitations also offer an opportunity for improving their management techniques.

Especially in making long-term loans, the borrower as well as the lender should be thinking of: (1) the net earning power of the borrowing company, (2) the capability of its management, (3) the long range prospects of the company, and (4) the long range prospects of the industry of which the company is a part. Such factors often mean that limitations increase as the duration of the loan increases.

What Kinds of Limitations?

The kinds of limitations, which an owner-manager finds set upon the company depends, to a great extent, on the company. If the company is a good risk, only minimum limitations need be set. A poor risk, of course, is different. Its limitations should be greater than those of a stronger company.

Look now for a few moments at the kinds of limitations and restrictions which the lender may set. Knowing what they are can help you see how they affect your operations.

The limitations which you will usually run into when you borrow money are:

(1) Repayment terms.
(2) Pledging or the use of security.
(3) Periodic reporting.

A loan agreement, as you may already know, is a tailor-made document covering, or referring to, all the terms and conditions of the loan. With it, the lender does two things: (1) protects his position as a creditor (he wants to keep that position in as well a protected details necessary for working up profit and loss statements, your Federal income tax returns (Schedule C of Form 1040, if your business is a sole proprietorship or a partnership) may be useful in getting together facts for the SBA loan application.

Insurance

SBA also needs information about the kinds of insurance a company carries. The owner-manager gives these facts by listing various insurance policies. If you place all your insurance with one agent or broker, you can get this information from him.

Personal Finances

SBA also must know something about the personal financial condition of the applicant. Among the types of information are: personal cash position; source of income including salary and personal investments; stocks, bonds, real estate, and other property owned in the applicant's own name; personal debts including installment credit payments, life insurance premiums, and so forth.

Cash Budget

(for three months, ending March 31, 19__)

	January		February		March	
	Budget	Actual	Budget	Actual	Budget	Actual
Expected Cash Receipts:						
1. Cash sales						
2. Collections on accounts receivable						
3. Other income						
4. Total cash receipts						
Expected Cash Payments:						
5. Raw materials						
6. Payroll						
7. Other factory expenses (including maintenance)						
8. Advertising						
9. Selling expense						
10. Administrative expense (including salary of owner-manager)						
11. New plant and equipment						
12. Other payments (taxes, including estimated income tax; repayment of loans; interest; etc.)						
13. Total cash payments						
14. **Expected Cash Balance** at beginning of the month						
15. Cash increase or decrease (item 4 minus item 13)						
16. Expected cash balance at end of month (item 14 plus item 15)						
17. Desired working cash balance						
18. Short-term loans needed (item 17 minus item 16, if item 17 is larger)						
19. Cash available for dividends, capital cash expenditures, and/or short term investments (item 16 minus item 17, if item 16 is larger than item 17)						
Capital Cash:						
20. Cash available (item 19 after deducting dividends, etc.)						
21. Desired capital cash (item 11, new plant equipment)						
22. Long-term loans needed (item 21 less item 20, if item 21 is larger than item 20)						

U.S. GOVERNMENT PRINTING OFFICE : 1978 O—

SMALL BUSINESS ADMINISTRATION

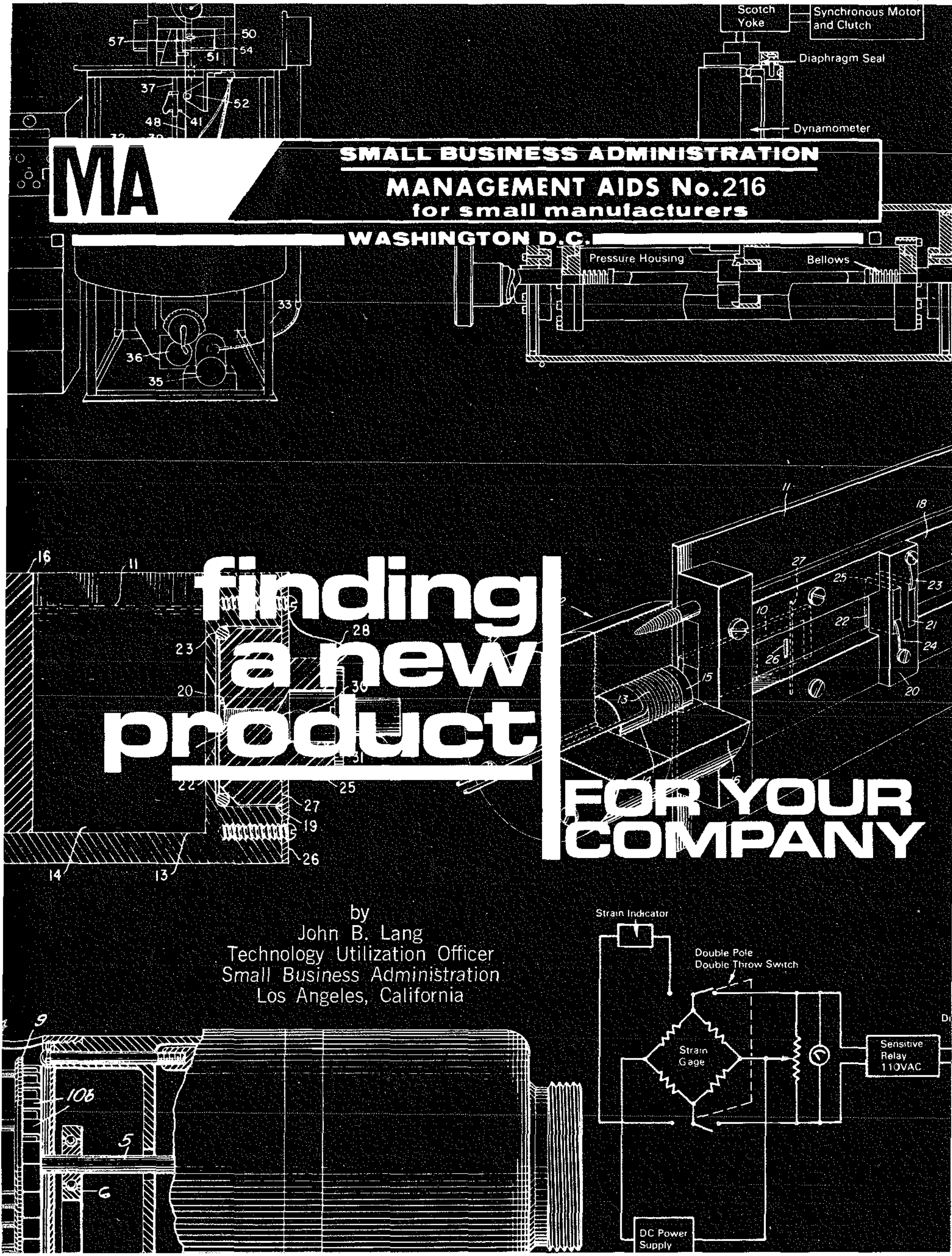
MA

MANAGEMENT AIDS No.216
for small manufacturers

WASHINGTON D.C.

finding a new product FOR YOUR COMPANY

by
John B. Lang
Technology Utilization Officer
Small Business Administration
Los Angeles, California



YOUR COMPANY'S STRENGTHS

	Yes	No
1. Is manufacturing your company's strength?	____	____
2. Do you prefer a highly automated production line?	____	____
3. Do you prefer a product with a high ratio of labor to production costs?	____	____
4. Are your production personnel highly skilled?	____	____
5. Are your industrial product designers exceptionally skilled?	____	____
6. Does your present equipment have a long usable life?	____	____
7. Is your present equipment largely underutilized?	____	____
8. Do you have a strong sales force?	____	____
9. Is your sales force hampered by too-narrow a product?	____	____
10. Do you have strong capability in a particular technology?	____	____
11. Does your company have cash or credit resources not used in your present operations?	____	____
12. Does your company have a reputation for high quality products?	____	____
13. Does your company have a reputation for low cost production?	____	____

MARKET PREFERENCE

	Yes	No
14. Do your prefer a particular industry?	____	____
15. Do you prefer a product sold to retail consumers?	____	____
16. Do you prefer a product sold to industrial users?	____	____
17. Do you prefer a product sold to the government?	____	____
18. Do you prefer a product with long usage?	____	____
19. Will you accept a product that may be a fad item?	____	____
20. Do you prefer a consumable item?	____	____
21. Is there a distribution system (trade practice) you prefer?	____	____
22. Would you consider a product limited to a given locality? (Or a product in demand largely in overseas markets?)	____	____
23. Is a product that requires specialty selling desirable?	____	____
24. Is a product that needs mass merchandising suitable?	____	____
25. Do you intend overseas distribution?	____	____
26. Must your present sales department be able to sell a new product?	____	____
27. Are you willing to create a new or separate marketing department to sell a new product?	____	____

53. Would a product requiring extensive quality control costs be desirable? ____ ____

FINANCE

	Yes	No
54. Has an overall budget been established for a new product?	____	____
55. Have separate budgets been established for finding, acquisition, development, market research, manufacturing, and marketing the new product?	____	____
56. Has a time period been established by which a new product must become self-supporting, profitable, or capable of generating cash?	____	____
57. Does the new product require a certain profit margin to be compatible with your financial resources or company objectives?	____	____
58. Has external long-range financing been explored for your new product?	____	____
59. Is the length of the sales cycle for the new product known?	____	____
60. Do trade practices require you to furnish financial assistance, such as floor planning or dating plans, for distribution of your product?	____	____
61. Have you determined average inventory to sales ratio for the new product?	____	____
62. Have you determined average aging of accounts receivable for your new product?	____	____
63. Does the product have seasonal aspects?	____	____

PROFILE OF PRODUCT INTEREST

Your answers to the 63 questions above can lead to a well thought-out guide as to the acceptability of any potential new product. A short condensed profile helps communicate your needs. Such a profile also indicates a high degree of professional management which sources of new products will welcome. For illustrative purposes a fictitious sample profile follows:

The XYZ company, a defense-aerospace oriented precision metal stamping and machine shop, desires to acquire a product or product line to the following specifications:

MARKET - - - - - The product desired is one for use by industrial or commercial firms of a specific industry but not by the government or general public except incidentally.

PRODUCT - - - - - The product sought is one in which 60 percent of the total direct manufacturing cost consists of metal stamping and/or machining processes.

PRICE RANGE - - Open, but preferably the unit price to the user will be in the $100 to $400 range.

VOLUME - - - - - Open, but preferably a product which aggressively marketed will produce $500,000 in sales the first year with an annual potential sale of 3 to 5 million dollars.

FINANCE - - - - - Initial resources to $150,000 in addition to present plant capacity are available for manufacturing a new product.

TYPE OF ACQUISITION - - Prefer royalties to a patent but will consider purchase of a patent, joint venture, merger, or purchase of a company outright.

LARGE CORPORATIONS. Most large corporations, especially aerospace companies, develop many new products. Because of company policy, many of these products although highly desirable are not suitable for their own manufacturing or marketing operations. Usually the large company will maintain a separate department or subsidiary company for the sole purpose of finding suitable licensees. In some cases these new product licenses include marketing studies, manufacturing know-how, and other pertinent information or services, which reduce the risk to the firm seeking a new product. This is considered one of the finest sources of new products.

INVENTORS SHOWS. The Chambers of Commerce in large metropolitan areas generally sponsor an annual "Inventors Show." The purpose of these shows is to enable manufacturers and inventors to get together to put new products on the market. Check with your local Chamber of Commerce for the dates of their next show or write to the Office of Inventions and Innovations, National Bureau of Standards, Washington, D. C. 20234, for a listing of the major inventors shows scheduled throughout the United States.

COMMERCIAL BANKS. One way to obtain a new product is to acquire all or part of another business. Many small companies with fine products may need the strengths of your company to become successful. These strengths may consist of equipment, facilities, personnel, or know-how in manufacturing, marketing, or management, as well as money.

Major banks will know of some of these situations. Normally, through their investment departments, they will arrange a meeting between companies or individuals with complementary interests in the expectation of receiving the banking business that might ensue. There is no charge for this service.

SMALL BUSINESS INVESTMENT COMPANIES (SBIC'S) AND INVESTMENT BANKERS. In the very nature of such companies, they continually are examining existing and potential businesses. Contacts with these firms could very well lead to a new product or an equity position in a business with desirable products. Your local SBA office can furnsh you with a list of licensed SBIC's in your area.

LICENSING BROKERS. A new type of consultant is the licensing broker. They are generally men with a wide acquaintance in the licensing field. Usually they represent companies seeking licensees (including foreign companies) as well as those searching for a product to license. Often they also have wide experience in developing fair and reasonable licensing agreements and can advise their clients accordingly.

FOREIGN LICENSES. The U.S. Department of Commerce publishes weekly *The International Commerce Magazine*. This contains a "Licensing Opportunities Section" in which are listed products for which foreign manufacturers are seeking U.S. firms to manufacture and sell these products to the U.S. market. The yearly subscription rate is $20. This may be ordered through the Department of Commerce local field office which will also have previous issues available for public inspection.

Also you may write a letter to your local Department of Commerce field office and enclose a copy of your firm's brochure and your "Profile of Product Industry." This information will be handled by their International Investment Section which will make every effort to put you in touch with a suitable foreign product licensor.

In larger metropolitan areas, you should contact the local Commercial Attachés of foreign countries, usually located at each country's embassy or consulate. They, too, are looking for appropriate licensees for products developed in their countries.

A word of caution is in order though in such instance. You should consult an attorney experienced in foreign licensing to prevent possible legal complications in the licensing procedure.

NEW PRODUCT ADVERTISING. Trade or industry periodicals and financial newspapers (such as *The Wall Street Journal*) often carry ads of new products available to a manufacturer. These ads could very well lead you to a new product.

U. S. GOVERNMENT PRINTING OFFICE : 1976 O - 202-752

However, looking through ads is a passive form of search. You might consider advertising in these publications as an active, aggressive form of search. A very condensed version of your "Profile of Product Interest" should make an ideal ad.

YOUR COMPANY'S BROCHURE. Before finding a new product, you may nter into negotiations with a number of people. To assist you in establishing a sound relationship with new product sources, it is suggested that you prepare a brochure on your firm. It may be very simple or as elaborate as you wish, but it should contain: a brief history of your firm's legal structure; information on your key personnel, plant, and equipment; descriptions of jobs or products handled and, if they are agreeable, some of your best customers; and financial statements and financial resources available.

FOR FURTHER INFORMATION

Readers interested in further exploring the subject of finding a new product may find the references listed below helpful. This list is necessarily brief and selective. However, no slight is intended toward authors whose works are not mentioned.

How to Develop New Products for Sale to Industry. F. Butrick. 1971. $19.50. Prentice-Hall, Englewood Cliffs, New Jersey 07632.

Handbook of New Product Development. Peter Hilton. 1961. $19.95. Prentice-Hall, Englewood Cliffs, New Jersey 07632.

Planning Corporate Growth and Diversification. Peter Hilton. 1970. Text ed. $10.95. McGraw-Hill, Inc., 330 West 42d Street, New York, New York 10036.

Concept & Practice of Product Planning. Gerd D. Wallenstein. 1968. $5.25; AMA members, $3.75. American Management Association, 135 West 50th Street, New York, New York 10020.

Technological Forecasting for Industry and Government. James Bright. 1968. $29.95. Prentice-Hall, Inc., Englewood Cliffs, New Jersey 07632.

Technology and Your New Products, SBMS No. 19, 2d ed. 1967. Small Business Administration. For current price write to Superintendent of Documents, Washington, D.C. 20402.

New Product Introduction for Small Business Owners, SBMS No. 17. Small Business Administration. For current price write to Superintendent of Documents, Washington, D.C. 20402.

"Wishing Won't Get Profitable New Products," *Management Aid* No. 92. Free from SBA, Washington, D.C. 20416 (or nearest SBA office).

"Are Your Products and Channels Producing Sales?" *Management Aid* No. 203. Free from SBA, Washington, D.C. 20416 (or nearest SBA office).

(Prices are subject to change.)

Having read the sample profile, it is suggested that you review the preceding questions. It will become apparent that the answer to almost any single question could completely change the profile of the product being sought. This stresses the importance to you of a thorough analysis of your firm's objectives and strengths as the basis for a profile of a product in which you would be interested. For example, suppose you are interested in a product at the patent or development stage. Can your company afford to take the risks involved? Are you prepared to meet the high costs of development? Have you taken into account the length of time before the product will be marketable? Or does your analysis indicate you should be looking for a fully developed product?

SUGGESTED SOURCES FOR NEW PRODUCTS

After having developed your Profile of Product Interest, you will have a practical gauge against which to measure new products. Where do you look for the products? A good idea for a new product can originate from almost any individual. However there are a number of sources that continually generate new products. A systematic search of these sources will almost certainly develop a choice from a number of products, any one of which could meet your needs. Suggested sources are:

GOVERNMENT-OWNED PATENTS. Generally any U.S. Government-owned patent is available on a non-exclusive royalty-free basis. Some government agencies will issue a license with some degree of exclusivity if no license has been requested after 2 years from the date of publication of the patent. Information on government-owned patents may be obtained from your local Small Business Administration office, the field office of the U.S. Department of Commerce nearest you, or by writing to the U.S. Patent Office, Department of Commerce, Washington, D. C. 20231.

Patent Abstracts Bibliography (PAB) is a semiannual publication listing NASA-owned patents and applications for patents as a service for those seeking new licensable products for the commercial market. PAB, which is identified as NASA-SP-7039, is available from the National Technical Information Service (NTIS), U.S. Department of Commerce, Springfield, Virginia 22151, for $6.00.

AEC-NASA Tech Briefs are 1- or 2-page descriptions of ideas, concepts, or patents for new products, innovations, applications, or processes. They are the result of work performed by or under contract to the Atomic Energy Commission or the National Aeronautics and Space Administration. These ideas and products are available to the general public. *AEC-NASA Tech Briefs* are available from NTIS. Your local SBA office can give you additional information on them.

Government Reports Topical Announcements (usually referred to as *Topical Announcements*) are current awareness announcements published semimonthly in 35 separate fields of technology. These announcements may be ordered from NTIS at $5.00 per category annually.

FAST Announcement Service on Selected Scientific and Technical Reports spotlights selected new reports as they are received by NTIS. Some 5,000 publications are reported annually. Selection is made on potential commercial applications of R&D reports. Biweekly announcements list titles and abstracts of papers on the latest advances in 57 categories. This service is intended to keep businessmen, scientists, and engineers abreast of their fields. Breakdown of category subunits is available on request. Annual subscription, one or more categories $5.00.

PRIVATE PATENTS. *The Official Gazette* of the U.S. Patent Office is published weekly and lists all the patents granted by the U.S. Patent Office. Annual subscriptions are available from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402. The *Gazette* contains a section that lists, one time only, patents available for sale or licensing.

There are a number of private publications in which patents available for licensing or sale are listed. One is *The Patent Exchange* published monthly at $1 per copy by The Patent Exchange, Inc., 26 Broadway, New York, N.Y. 10004. Your local library should be able to give you complete listing of all such private publications.

The patent attorneys in your area are another source of new products.

SALES VOLUME DESIRED

	Yes	No
28. Have you determined the optimum annual volume from the product over the next 3 years?	____	____
29. Do you have any preference for a unit price range in a product?	____	____
30. Do you have 5 and 10 year volume objectives for a new product?	____	____
31. Will this product have to support its own sales organization?	____	____
32. Will the product support its own manufacturing equipment?	____	____
33. At what volume does a product exceed your company's capability?	____	____

PRODUCT STATUS

	Yes	No
34. Will you accept an idea for a product?	____	____
35. Will you accept an unpatentable product?	____	____
36. Is a non-exclusive license of a patent acceptable?	____	____
37. Are you willing to develop an idea to a patentable stage?	____	____
38. Will you develop a patent without acceptable prototype?	____	____
39. Will you accept a product that has been on the market but is not yet profitable?	____	____
40. Will you license a patent?	____	____
41. Do you insist on owning the product's patent?	____	____
42. Will you enter a joint venture for a new product with another company?	____	____
43. Would you merge with or buy a company that has good products but needs your company's strengths in manufacturing, sales, finances, or management?	____	____

THE PRODUCT CONFIGURATION

	Yes	No
44. Are there any maximum size limitations to a product you can manufacture?	____	____
45. Would weight of a product be a factor?	____	____
46. Do warehousing facilities or yard space imimpose size limitation?	____	____
47. Does length of production time influence the desirability of a product?	____	____
48. Have you determined your equipment tolerance?	____	____
49. Do you have adequately trained personnel to do the job?	____	____
50. Would you prefer that a product be made of certain materials?	____	____
51. Are there manufacturing processes that should constitute the major portion of a new product?	____	____
52. Are there any manufacturing processes the product should not have?	____	____

SUMMARY

Sometimes the only way a small manufacturer can expand his sales is by introducing a new product. The products he makes have reached their sales peak. Moreover, they cannot be modified to generate additional sales.

It becomes a question of where to look for a new product that can be made and sold at a profit. This Aid speaks to that question. It discusses a practical approach to the selection of a suitable new product and suggests sources that can be helpful to finding such a product.

FIRST PRINTED
NOVEMBER, 1972

A systematic approach is the best way to find a new product. In such an approach, your first action should be to set a new product policy. Before you start to search for a new product, set guidelines for that search.

These guidelines should help to provide answers to questions, such as: Can the new product be made on present equipment? Will it be sold to your present market? What is the profit potential of the new product?

The second major action involves responsibility for finding a new product. Will you personally handle the project? Or will you delegate it to one of your key men? Either way, the person who looks for the new product should have a clear understanding of the resources at his disposal. In addition, he should be authorized to make decisions for your company.

DEFINING A NEW PRODUCT FOR YOUR COMPANY

Although there are thousands of products available on a reasonable basis to any company that will manufacture and market them, the question is: Which ones can be made at a profit? In fact, so many exist and are being generated, it would consume all the resources of a small company to examine each of them only briefly. On the other hand, too brief a search or a hasty decision can result in costly mistakes, if not outright disaster. It is thus imperative to define the product you are seeking.

Your task is to get on paper some facts about the kind of new product you want to produce in your factory. These facts consist of your requirements in general terms which will be applicable to a new product. The following questions, though not all inclusive, should stimulate your thinking in defining a product or establishing criteria by which you can judge potential products. When you have set such criteria, you can write a "profile of product interest."

Evaluating the Application

Once you have supplied the necessary information, the next step in the borrowing process is the evaluation of your application. Whether the processing officer is in a bank or in SBA, he considers the same kinds of things when determining whether to grant or refuse the loan. The SBA loan processor looks for:

(1) The borrower's debt paying record to suppliers, banks, home mortgage holders, and other creditors.

(2) The ratio of the borrower's debt to his net worth.

(3) The past earnings of the company.

(4) The value and condition of the collateral which the borrower offers for security.

The SBA loan processor also looks for: (1) the borrower's management ability, (2) the borrower's character, and (3) the future prospects of the borrower's business.

state as it was on the date the loan was made) and (2) assures himself of repayment according to the terms.

The lender reasons that the borrower's business should **generate enough funds** to repay the loan while taking care of other needs. He considers that cash inflow should be great enough to do this without hurting the working capital of the borrower.

Covenants—Negative and Positive

The actual restrictions in a loan agreement come under a section known as covenants. Negative covenants are things which the borrower may not do without prior approval from the lender. Some examples are: further additions to the borrower's total debt, nonpledge to others of the borrower's assets, and issuance of dividends in excess of the terms of the loan agreement.

On the other hand, positive covenants spell out things which the borrower must do. Some examples are: (1) maintenance of a minimum net working capital, (2) carrying of adequate insurance, (3) repaying the loan according to the terms of the agreement, and (4) supplying the lender with financial statements and reports.

Overall, however, loan agreements may be amended from time to time and exceptions made. Certain provisions may be waived from one year to the next with the consent of the lender.

You Can Negotiate

Next time you go to borrow money, thrash out the lending terms before you sign. It is good practice no matter how badly you may need the money. Ask to see the papers in advance of the loan closing. Legitimate lenders are glad to cooperate.

Chances are that the lender may "give" some on the terms. Keep in mind also that, while you're mulling over the terms, you may want to get the advice of your associates and outside advisors. In short, try to get terms which you know your company can live with. Remember, however, that once the terms have been agreed upon and the loan is made (or authorized as in the case of EBA), you are bound by them.

The Loan Application

Now you have read about the various aspects of the lending process and are ready to apply for a loan. Banks and other private lending institutions, as well as the Small Business Administration, require a loan application on which you list certain information about your business.

For purposes of explaining a loan application, this **Aid** uses the Small Business Administration's application for a loan (SBA Form 4). The SBA form is more detailed than most bank forms. The bank has the advantage of prior knowledge of the applicant and his activities. Since SBA does not have such knowledge, its form is more detailed. Moreover, the longer maturities of SBA loans ordinarily will necessitate more knowledge about the applicant.

Before you get to the point of filling out a loan application, you should have talked with an SBA representative, or perhaps your accountant or banker, to make sure that your business is eligible for an SBA loan. Because of public policy, SBA cannot make certain types of loans. Nor can it make loans under certain conditions. For example, if you can get a loan on reasonable terms from a bank, SBA cannot lend you money. The owner-manager is also not eligible for an SBA loan if he can get funds by selling assets which his company does not need in order to grow.

When the SBA representative gives you a loan application, you will notice that most of its sections ("Application for Loan"—SBA Form 4) are self-explanatory. However, some applicants have trouble with certain sections because they do not know where to go to get the necessary information.

Section 3—"Collateral Offered" is an example. A company's books should show the net value of assets such as business real estate and business machinery and equipment. "Net" means what you paid for such assets less depreciation.

If an owner-manager's records do not contain detailed information on business collateral, such as real estate and machinery and equipment, he sometimes can get it from his Federal income tax returns. Reviewing the depreciation which he has taken for tax purposes on such collateral can be helpful in arriving at the value of these assets.

If you are a good manager, you should have your books balanced monthly. However, some businesses prepare balance sheets less regularly. In filling out your "Balance Sheet as of ________, 19__, Fiscal Year Ends ________," remember that you must show the condition of your business within 60 days of the date on your loan application. It is best to get expert advice when working up such vital information. Your accountant or banker will be able to help you.

Again, if your records do not show the

forecast is your estimates of cash receipts and disbursements during the budget period. Thus, the budget and the cash forecast together represent your plan for meeting your working capital requirements.

To plan your working capital requirements, it is important to know the "cash flow" which your business will generate. This involves simply a consideration of all elements of cash receipts and disbursements at the time they occur. These elements are listed in the profit-and-loss statement which has been adapted to show cash flow in the box on page 7. They should be projected for each month.

What Kind of Collateral?

Sometimes, your signature is the only security the bank needs when making a loan. At other times, the bank requires additional assurance that the money will be repaid. The kind and amount of security depends on the bank and on the borrower's situation.

If the loan required cannot be justified by the borrower's financial statements alone, a pledge of security may bridge the gap. The types of security are: endorsers, comakers, and guarantors; assignment of leases; trust receipts and floor planning; chattel mortgages; real estate; accounts receivables; savings accounts; life insurance policies; and stocks and bonds. In a substantial number of States where the Uniform Commercial Code has been enacted, paperwork for recording loan transactions will be greatly simplified.

Endorsers, Co-makers, and Guarantors

Borrowers often get other people to sign a note in order to bolster their own credit. These **endorsers** are contingently liable for the note they sign. If the borrower fails to pay up, the bank expects the endorser to make the note good. Sometimes, the endorser may be asked to pledge assets or securities that he owns.

A co-maker is one who creates an obligation jointly with the borrower. In such cases, the bank can collect directly from either the maker or the co-maker.

A guarantor is one who guarantees the payment of a note by signing a guaranty commitment. Both private and government lenders often require guarantees from officers of corporations in order to assure continuity of effective management. Sometimes, a manufacturer will act as guarantor for one of his customers.

Assignment of Leases

The assigned lease as security is similar to the guarantee. It is used, for example, in some franchise situations.

The bank lends the money on a building and takes a mortgage. Then the lease, which the dealer and the parent franchise company work out, is assigned so that the bank automatically receives the rent payments. In this manner, the bank is guaranteed repayment of the loan.

Warehouse Receipts

Banks also take commodities as security by lending money on a warehouse receipt. Such a receipt is usually delivered directly to the bank and shows that the merchandise used as security either has been placed in a public warehouse or has been left on your premises under the control of one of your employees who is bonded (as in field warehousing). Such loans are generally made on staple or standard merchandise which can be readily marketed. The typical warehouse receipt loan is for a percentage of the estimated value of the goods used as security.

Trust Receipts and Floor Planning

Merchandise, such as automobiles, appliances, and boats, has to be displayed to be sold. The only way many small marketers can afford such displays is by borrowing money. Such loans are often secured by a note and a trust receipt.

This trust receipt is the legal paper for floor planning. It is used for serial-numbered merchandise. When you sign one, you (1) acknowledge receipt of the merchandise, (2) agree to keep the merchandise in trust for the bank, and (3) promise to pay the bank as you sell the goods.

Chattel Mortgages

If you buy equipment such as a cash register or a delivery truck, you may want to get a chattel mortgage loan. You give the bank a lien on the equipment you are buying.

The bank also evaluates the present and future market value of the equipment being used to secure the loan. How rapidly will it depreciate? Does the borrower have the necessary fire, theft, property damage, and public liability insurance on the equipment? The banker has to be sure that the borrower protects the equipment.

Real Estate

Real estate is another form of collateral for long-term loans. When taking a real estate

Introduction

Inexperience with borrowing procedures often creates resentment and bitterness. The stories of three small businesspersons illustrate this point.

"I'll never trade here again," Bill Smith* said when his bank refused to grant him a loan. "I'd like to let you have it, Bill," the banker said, "but your firm isn't earning enough to meet your current obligations." Mr. Smith was unaware of a vital financial fact, namely, that lending institutions have to be certain that the borrower's business can repay the loan.

Tom Jones lost his temper when the bank refused him a loan because he did not know what kind or how much money he needed. "We hesitate to lend," the banker said, "to business owners with such vague ideas of what and how much they need."

John Williams' case was somewhat different. He didn't explode until after he got the loan. When the papers were ready to sign, he realized that the loan agreement put certain limitations on his business activities. "You can't dictate to me," he said and walked out of the bank. What he didn't realize was that the limitations were for his good as well as for the bank's protection.

Knowledge of the financial facts of business life could have saved all three men the embarrassment of losing their tempers. Even more important, such information would have helped them to borrow money at a time when their businesses needed it badly.

This **Aid** is designed to give the highlights of what is involved in sound business borrowing. It should be helpful to those who have little or no experience with borrowing. More experienced owner-managers should find it useful in re-evaluating their borrowing operations.

*** All names in *Aids* are disguised.**

Is Your Firm Credit Worthy?

The ability to obtain money when you need it is as necessary to the operation of your business as is a good location or the right equipment, reliable sources of supplies and materials, or an adequate labor force. Before a bank or any other lending agency will lend you money, the loaning officer must feel satisfied with the answers to the five following questions:

1. What sort of person are you, the prospective borrower? By all odds, the character of the borrower comes first. Next is his ability to manage his business.

2. What are you going to do with the money? The answer to this question will determine the type of loan—short- or long-term. Money to be used for the purchase of seasonal inventory will require quicker repayment than money used to buy fixed assets.

3. When and how do you plan to pay it back? Your banker's judgement as to your business ability and the type of loan will be a deciding factor in the answer to this question.

4. Is the cushion in the loan large enough? In other words, does the amount requested make suitable allowance for unexpected developments? The banker decides this question on the basis of your financial statement which sets forth the condition of your business and/or on the collateral pledge.

5. What is the outlook for business in general and for your business particularly?

Adequate Financial Data Is a "Must."

The banker wants to make loans to businesses which are solvent, profitable, and growing. The two basic financial statements he uses to determine those conditions are the balance sheet and profit-and-loss statement. The former is the major yardstick for solvency and the latter for profits. A continuous series of these two statements over a period of time is the principal device for measuring financial stability and growth potential.

In interviewing loan applicants and in studying their records, the banker is especially interested in the following facts and figures.

General Information: Are the books and records up-to-date and in good condition? What is the condition of accounts payable? Of notes payable? What are the salaries of the owner-manager and other company officers? Are all taxes being paid currently? What is the order backlog? What is the number of employees? What is the insurance coverage?

Accounts Receivable: Are there indications that some of the accounts receivable have already been pledged to another creditor? What is the accounts receivable turnover? Is the accounts receivable total weakened because many customers are far behind in their payments? Has a large enough reserve been set up to cover doubtful accounts? How much do the largest accounts owe and what percentage of your total accounts does this amount represent?

Inventories: Is merchandise in good shape or will it have to be marked down? How