U.S. Small Business Administration

SBA

Your Small Business Resource

ABC's of Borrowing Money

Financial Management Series

U. S. Small Business Administration
March 2009

*Helping Small Business **Start**, **Grow** and **Succeed***

ABC's of Borrowing Money

Financial Management Series
FM -1

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TABLE OF CONTENTS

INTRODUCTION

All businesses, no matter what size, will at some time need to raise more money. For small businesses, the owner may be able to dip into his or her personal savings, or friends may be able to lend the needed money. Usually, however, the owner will have to look to outside sources for financing.

IS YOUR FIRM CREDIT WORTHY?

Obtaining 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 feel satisfied with the answers to the following 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?
- What is the specific purpose of the loan? Is it a short- or long-term need?
- Do you have a clear financial plan and forecast showing why you need the loan and how you will pay it back?
- Is the loan request large enough to cover any unexpected change in your situation, but not so large that its repayment will be a heavy burden?
- What is the general 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 and the income statement is the common measure of profits. Using these and other sources, lenders ask the following questions.

General Questions

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

Accounts Receivable

- What is the quality of the accounts receivable?
- Have any been pledged to another creditor?
- Are customers paying you promptly?
- Is there an allowance for bad debts?

Inventory

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

Fixed Assets and Equipment

- What is the type, age and condition of equipment?
- What are the depreciation schedules?
- What are the details of mortgages or leases?
- What are the future fixed asset and equipment needs for the company?

The lender scrutinizes the cash flow of the business to determine whether or not 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, such as the acquisition of fixed assets, thereby reducing liquidity.

WHAT TYPE OF LOAN?

When you set out to borrow money for your firm, it is important to know the type of loan you want and its 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 a very important factor in deciding what kind of loan to request. There is 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 the current assets (i.e., receivables, inventory) that are financed, while long-term loans are generally repaid from earnings.

Line of Credit

A line of credit is 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 installment loan is an agreement to provide a lump sum amount of money at the beginning of the loan. The loan is paid back in equal amounts over the course of a number of years.

Short-term loan

A short-term bank 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, account receivable loans when the outstanding accounts have been paid by the customers and inventory loans when the inventory has been sold and cash collected. Short-term loans are generally repaid in less than a year.

Long-term loan

A long-term loan is usually a formal agreement to provide funds for more than one year, and most are for an improvement that will benefit the company and increase earnings. An example is the purchase of a new building that will increase capacity or of a machine that will make the manufacturing process more efficient and less costly. 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, Co-maker, Guarantor

A borrower may ask another person to sign a note in order to augment his or her 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.

A co-maker is an endorser who assumes an obligation jointly with the maker, or borrower. In this arrangement, the bank can collect directly from either maker or co-maker.

A guarantor is an endorser who guarantees the payment of a note if the borrower does not pay. Both private and government lenders often require guarantees from officers of corporations in order to assure continuity of effective management.

Warehouse Receipts

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 has been left on your premises under the control of one of your employees who is bonded. 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, such as a cash register or a 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, 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.

Accounts Receivable

Many banks lend money against accounts receivable; in effect, counting 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 continue to pay you and you pay the bank.

Inventory

Inventory is the merchandise, wares and any assets that can be liquidated of a retail, wholesale or manufacturing business that will provide a form of financial guarantee against the 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 and Certificates of Deposit

It is possible to get a loan by assigning a savings account 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 generally is 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 percent or less on the value of high-grade stocks and up to 90 percent on government securities. The limits leave a cushion or margin for protection against declines. If the market value of the collateral does fall below a certain level, the bank may ask for additional collateral or a partial payment of the loan.

LOAN AGREEMENT

A loan agreement is a tailor-made document, fully stating all 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 in a loan agreement 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. A higher risk company, on the other hand, 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 and Positive

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 the borrower must agree to. 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 from time to time 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 is good practice, no matter how much you need the money. Chances are the lender may be willing to give on some of the terms; try to get terms with which you know your company can live. Remember, though, that once the loan is made, you are bound by it.

LOAN APPLICATION

Banks and other lending institutions, including the SBA, require a loan application on which you list certain information about your business.

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 have such knowledge. Also, the longer maturities offered on SBA loans ordinarily require more information about the applicant.

Before you fill out a loan application, you should talk with an SBA representative, or 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 qualify for a loan on reasonable terms from a bank, SBA cannot lend you money. You also are not eligible for an SBA loan if you can get funds by selling assets that your company does not need in order to grow. Most sections of the SBA loan application are self-explanatory; however, some applicants have trouble with certain sections because they do not know where to get the necessary information requested.

The collateral section is an example. Collateral is the borrower's assets that are pledged 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 means what you paid for such assets less depreciation.) If your records do not contain detailed information on these assets, the bank sometimes can 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 a good manager, you probably balance your books every month. Some businesses, however, prepare balance sheets less regularly. In filling out your Balance Sheet as of ________, 20___, 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 this vital information. Your accountant or banker can help you.

Again, 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.

APPENDIX A:

GLOSSARY

Accounts receivable -- Money your customers owe you that you have sent them a bill for.

Bad debt -- Money owed to you that is not repaid.

Cash flow -- The movement of money into and out of your business.

Collateral -- Item (equipment, property, etc.) that is pledged to guarantee a loan.

Covenant -- Prescription for action in a loan agreement.

Current assets -- Money, inventory and equipment that will be used up in the short term (usually within one year).

Depreciation schedule -- Accounting procedure for determining the amount of value left in a piece of equipment.

Financial forecast -- Projection of revenues and expenses for the next one to five years.

Financial plan -- Outline for how to use the money (capital) you have and how to raise the money you will need.

Fixed assets -- Equipment, buildings, etc., that are purchased and used for long-term purposes.

Inventory -- Merchandise that is purchased and/or produced and stored for eventual sale.

Inventory turnover -- How often the inventory is sold and replenished in one year.

Liquidation -- Sale of products or merchandise.

Long term -- Period usually greater than one year.

Obligation -- Money, merchandise or service owed to someone. Another term for debt.

Short term -- Period usually one year or less.

Solvency -- The ability to continue business.

Working capital -- Cash and short-term assets that can be used for current needs (bills, etc.).

APPENDIX B:

ELECTRONIC FORMS

SBA Application for a Business Loan	http://www.sba.gov/idc/groups/public/documents/sba_homepage/tools_sbf_formssb4.pdf
Schedule of Collateral	http://www.sba.gov/idc/groups/public/documents/sba_homepage/tools_sbf_finasst4a.pdf
Balance Sheet	http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_010150.xlt
Income Statement	http://www.sba.gov/idc/groups/public/documents/sba_homepage/form_finasst_incomestmt.xlt
Cash Flow Statement	http://www.sba.gov/idc/groups/public/documents/sba_homepage/form_finasst_cshflstmt.xlt
Personal Financial Statement	http://www.sba.gov/idc/groups/public/documents/sba_homepage/tools_sbf_finasst413.pdf

APPENDIX C:

INFORMATION RESOURCES

The SBA offers an expansive network of business resources to assist small business customers. Use these resources to help build a successful business.

Small Business Training Network (SBTN)
The SBA operates a virtual campus featuring numerous free online courses. The courses cover a variety of topics, including how to start a business, finance, business planning, marketing, management, technology, government contracting and many other topics. Approximately 1,500 small business customers each day register for SBA's free online courses.

Small Business Development Centers (SBDC)
The Office of Small Business Development Centers (SBDC) provides management assistance to current and prospective small business owners. SBDCs offer one-stop assistance to individuals and small businesses by providing a wide variety of information and guidance in central and easily accessible branch locations. The program is a cooperative effort of the private sector, the educational community and federal, state and local governments and is an integral component of Entrepreneurial Development's network of training and counseling services.

SCORE
SCORE (Counselors to America's Small Business) is a resource partner of the SBA dedicated to entrepreneur education and the formation, growth and success of small businesses nationwide. There are more than 10,500 SCORE volunteers in 374 chapters operating in over 800 locations who assist small businesses with business counseling and training. SCORE also operates an active online training and counseling program.

Women's Business Centers (WBC)
Women's Business Centers represent a national network of nearly 100 educational centers designed to assist women. WBCs help entrepreneurs, especially women who are economically or socially disadvantaged, to start and grow successful small businesses.

SBA District Offices
In addition to its resource partners, the SBA operates full service district offices in every state of the country. Locate the district office closest to you.

Other Targeted Resources

FREE Online Course: Finance Primer: Guide to SBA's Loan Guaranty Programs	http://web.sba.gov/sbtn/registration/index.cfm?CourseId=29
FREE Online Course: How to Prepare a Loan Package	http://web.sba.gov/sbtn/registration/index.cfm?CourseId=28
FREE Online Marketing Course	http://web.sba.gov/sbtn/registration/index.cfm?CourseId=30

URL Directory of Hyperlinks

Small Business Training Network	http://www.sba.gov/services/training/onlinecourses/index.html
Small Business Development Centers	http://www.sba.gov/aboutsba/sbaprograms/sbdc/index.html
SCORE	http://www.score.org/index.html
Women Business Centers	http://www.sba.gov/services/counseling/wbc/index.html
SBA District Offices	http://www.sba.gov/localresources/index.html

Have a Question?

E-Mail SBA - answerdesk@sba.gov
Ask a SCORE counselor online
Find a SBA district office near you
Find a SBDC office near you