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Finance Aquisition For The Small Firm

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FINANCE ACQUISITION FOR THE SMALL FIRM

by

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Chairman

Dean of the Graduate School

PREFACE

Money is the life blood of a business. The possession or lack of this vital necessity can result in success or failure for business venture--whether large or small--in a free enterprise system.

The small business manager or entrepreneur must be a "jack of all trades," for he usually must manage the purchasing, production, sales, finance, etc., functions, himself. Finance, since it is, as mentioned above, a firm's life blood, is one of the most important functions. One of the most difficult tasks falling under financial management is the acquisition of additional money.

This report is concerned with the methods available to the small business entrepreneur for acquiring additional captial for his business, and also an investigation and analysis of problems attendant thereto.

During the preparation of the study the utilization of many Small Business Administration (SBA) publications too numerous to mention was made.

The author is especially indebted for the helpful, frequent, and freely given assistance provided by the Regional Manager of the Small Business Administration at Fargo, North Dakota.

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ABSTRACT

In providing financing or raising capital, the owner-managers of small businesses are frequently not aware of all the sources of funds that are available. A better understanding of these different sources of money could remove a big stumbling block to small business financing.

The owner-manager of a small firm should know all about the sources of funds--what the different sources are, where they can be obtained, how they can be obtained, who authorizes their release, what requirements must be met to secure them, when and how they must be repaid, etc.

On the other hand, the owner-manager of a small firm should also be aware of some of the problems that are inherent in small business financing. If he is aware of the problems or possible pitfalls he may then attempt to steer clear of them.

It was with the goal in mind of making these money sources, their acquisition, and their attendant problems better known, that this study was written.

CHAPTER I

THE ORDINARY METHODS OF FINANCING

Some small businessmen get into financial trouble because they do not realize there are distinctions in the various sources of funds used in business. Often such men get pushed by circumstances into reaching for whatever source is handy when they need it.

A big danger in this approach is that some owner-managers try to operate with the wrong type of financing for a particular situation. For instance, some of them try to lean on their suppliers, using this convenient form of financing (normal trade credit), to cover a situation that requires a bank loan.

Actually, there are four ordinary kinds of financing that a small business needs from time to time. They are:

1. Very Short Term Financial Assistance
2. Short-Term Bank Loans
3. Term Borrowing
4. Equity (Investment) Capital

The purpose for which the funds are to be used is an important factor in deciding which source of financing is needed. The handiest source of financing may not be the right source for the particular business at that time. Some discussion of the basic four sources of financing may help to

ırther clarify what the four sources are and when they
ıould be used.

ery Short Term Financial Assistance

Included in very short term financial assistance are the following:

1. Trade credit
2. Discounted customer's notes
3. Installment paper
4. Commercial factors

These forms of very short term financial assistance all have one thing in common. They are usually granted on the credit reputation of the business and require a minimum of prearrangement between the business and the person who grants the credit.

Trade credit, in a sense, is a courtesy which businessmen extend to each other. Suppliers give it to manufacturers when the manufacturers buy raw materials etc., from them. Manufacturers, in turn, extend trade credit to the distributors, wholesalers, etc., who buy the products from them.

Trade credit works fine as long as everyone in the pipeline pays when he sould. Trouble comes when an attempt is made to make it do more than it is supposed to do, or more than it is possible to do.

Trade credit is convenient because the manager doesn't have to fill out applications or other formal papers, and he may usually handle it as a bookkeeping transaction.

Customer notes are another source of very short term funds. The bank will buy customer's notes or it will advance money against them.

A third source of these funds is installment paper. Some small businessmen sell the installment promissory notes which their customers give them for products such as appliances, etc.

The fourth and final source is commercial factors. A business sells its accounts receivable. If they are sold "without recourse," the buyer (or factor) assumes any loss resulting from uncollected accounts.

The factor's commission is generally based on the net face value of the receivables that are sold to him. It varies with the commodity, of course, but it usually amounts to from 1 to 3 percent.

Short-Term Bank Loans

The manager can use short-term bank loans for purposes such as financing accounts receivable for, say, 30 to 60 days. On the other hand, he can use them for purposes that take longer to pay off, such as for building a seasonal inventory over a period of several months.

Banks grant such financing either on general credit reputation with an unsecured loan, or on a secured loan against collateral or security.

The unsecured loan is the most frequently used form of bank credit for short-term purposes. The manager does not have to put up collateral because the bank relies on his credit reputation as sufficient security.

The secured loan gives the entrepreneur money against some of his 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 seem assured.

One type of secured loan is that in which one pledges or assigns his accounts receivable as security. The lender will usually advance from 50 to 90 percent of the value of the pledged receivables. Other types of collateral which may be used are inventories (both finished goods and raw materials) and plant and equipment. The lender will usually advance from 50 to 90 percent of the value of your pledged inventories, depending upon the nature of the product and its marketability.

Trade acceptances can be used as a basis for loans in this fashion: When the businessman sends his invoice to customer X, he can send along a trade acceptance form filled out for the amount due (usually he sends the document only when the amount involved is fairly large). Customer X now can (a) pay the bill at once, or (b) "accept" the trade acceptance, that is, he signs it, dates it, and writes the words "accepted payable at........" across the document's face. He then returns it.

The businessman, on the other hand, also has two choices. He can (a) hold the trade acceptance until shortly before the bill's due date and then forward it to the bank designated by the seller or send it directly to his office; or (b) if he needs the cash before the bill is due, he can discount the trade acceptance at his bank or sell it in the open market (through brokers or commercial paper houses). If he proceeds in the latter fashion, he can use the funds due him long before the actual date when the cash would have been available to his account.

In short-term money situations, the bank can set up helpful arrangements. For instance, it may extend to the entrepreneur a line of credit. A line of credit helps him to avoid delays in getting loans when he needs them.

Also, the bank can arrange for him to have revolving credit. It gives him a maximum line of credit. He can borrow against it, repay, and borrow again.

Many banks require an annual clean-up by the borrowers of short-term money. One has to be out of debt to the bank at least once during the year, in other words.

Term Borrowing

Term borrowing provides money repayable over a fairly long time. Frequently it is broken 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 purposes of matching the source of financing to the needs of the company, term borrowing should be thought of as a kind of money which will probably be paid back in installments over several years.

For instance, it could be thought of as money which might be used to pay for a $12,000 machine. In such a case, the purchaser and the bank, or some other financial institution, agree on terms when the purchaser discusses the loan. The purchaser might, for instance, repay the $12,000 in four payments of $3,000, or in some similar fashion.

Equity (Investment) Capital

Some people tend to confuse term borrowing and equity (or investment) capital. One reason is that both kinds of money can be used for the same types of things.

Yet there is a big difference. One doesn't have to repay equity capital funds. It is money obtained by selling an interest in the business.

The businessman takes people into his company who are willing to risk their money on it. They are interested in potential income rather than in an immediate return on their investment.

Suppose, for example, that the entrepreneur is in a new kind of business, one in which the risks are still in an indefinite state. Banks and other financial institutions cannot afford to lend their depositors' money in such uncertain circumstances.

Or it may be that he has borrowed all that he can. He is not over-extended, but his collateral is covered by credit. He has no more collateral to offer banks and other lending institutions.

In such cases, equity capital offers a source of funds. To secure this equity capital he may offer for sale part of his business to a person (or to an organization, such as a small business investment company) who is willing to take unusual risks and who can afford to wait over a relatively long period of time for a return on his money.

Small business firms are generally not able to find a readily available capital market. This makes it difficult to grow. However, these firms must always depend upon personal investment as a source of equity funds. One survey has stated, "Approximately 70 percent of the surveyed firms reported an increase in equity capital through the device of retained earnings or personal investment."[1]

Other Aspects

Even if one is aware of the different sources of financing available it is frequently difficult to decide which kind to use. Determining which source to use is sometimes complicated by the fact that one may be using various kinds of money at the same time.

For example, one might be: (1) financing accounts receivable with normal trade credit, (2) using short-term bank loans to build inventory for a seasonal peak, (3) paying for certain equipment with term borrowing, or (4) taking care of expansion demands with equity money.

There are, however, two things which can be helpful when the businessman is deciding what kind of money he needs. One

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[1]Pugh, Olin S., "Facts About Small Business Financing," Management Research Summary, Small Business Administration, January, 1962.

is purpose. He must determine what purpose the money will be used for.

The other is a review of his financial records. Such a review can help to answer questions such as: What kind of money has been used? What has been his experience with it? How much? When? Was it enough to do the job? Was it repaid as planned? Or was there trouble paying back certain kinds of money? Did a particular kind turn out to be more expensive than planned?

Good financial records can help to get the facts. For instance, cash-flow statements should show where operating money is coming from and where it is going. The budget should show an estimate of income and expenses for at least 12 months.

Some businessmen make the mistake of trying to operate with too small an amount of money. This is dangerous because sometimes even a small unexpected turn of events may put their firms in jeopardy.

The businessman should analyze his records to determine whether or not: (1) the trend over the last 4 or 5 years indicates that he is relying too heavily on normal trade credit for short term needs, (2) he could save money and operate easier by using some short-term bank loans, or (3) he could save by consolidating debts into one periodic payment instead of straining to pay a host of smaller bills each month.

In effect, one should use his records as guides when figuring out future needs. Yet, should not be held back or hidebound by the past. Rather, past records should be used to work for him to indicate where changes should be incorporated, and where improvements should be made.

One improvement that is worthwhile thinking about is timing. Some businessmen always borrow under pressure. They fail to investigate possible sources of additional funds until they actually need it. Then their company's immediate requirements often force them into arrangements that are not the most profitable.

The thing to remember, then, is timing. The manager should try to determine money needs ahead of time and plan so that he can have flexibility when he is rea[illegible] negotiate a loan. This should allow sufficient time to che[illegible] possibilities when money sources are being sought.

Sometimes the businessman may [illegible] able to get exactly the credit deal that he wants. Yet [illegible] aware of all the available sources and the effect that each might have on his business, can help him to select the second best, or even the third best credit deal, when he is forced to by prevailing conditions.

He may want to go one step further after he has determined what kind of money he needs for a particular situation. He may want to list the possible sources of money.

Very short term financing, of course, is obtained through creditors; banks would arrange a secured or unsecured loan; insurance companies and other financial institutions offer possibilities for term borrowing; and one of the small business investment companies, or possibly an individual person, would be a source of equity capital.

One thing that should be borne in mind is that the negotiation of equity capital takes time, so plans to gather the facts about such sources should be made well in advance of the time when one might need to start negotiations.

It appears evident that many small businessmen are not regular borrowers. A financial survey report has stated, "Slightly fewer than 60 percent of the smaller firms surveyed were active borrowers."[2]

Finally, an important thing for the small businessman to keep in mind is that money sources should be reviewed at least once a year so as to keep them up-to-date.

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[2] *Ibid*.

CHAPTER II

OTHER WAYS OF PROVIDING CAPITAL

The need for ready cash may arrive at a firm at any time. It may well arrive when business is good-when sales have just increased, but cash (for paying for raw materials, over-time, overhead, etc.) has not. It may arrive when the owner-manager is ready to add a new line that promises new profits, only to find himself hampered by a cash shortage.

In this chapter attention is given to ways of financing, of providing capital for the firm, other than those ordinary financing methods described in the previous chapter. This is done because it might not be feasible or possible to use any of the ordinary financing methods in certain situations.

The other ways of providing capital are to: (1) streamline internal operations, (2) tighten-up external relationships, and (3) get rid of fringe assets. These additional sourses of capital are within the average owner-manager's grasp, but they can be tapped only is he has provided good management, including close control over operations. The first two sources, of course, require more time to achieve the desired results, and are indirect as opposed to direct ways of providing capital

In order to streamline internal operations, careful attention should be paid to the following:

1. Receivables
2. Raw materials and finished goods inventories
3. Work-in-process
4. Backlogs
5. Bank account
6. Tax Liability

By tightening credit and collection policies, the businessman can reduce the outstanding amount of receivables, and increase cash in-flow. The ready cash is now available to use as necessary.

By temporarily reducing the purchases of raw materials which he does not need for immediate production, by purchasing components, parts and even services from others, and by deferring payments for such purchases until close to the moment when he received payments for finished goods, depletion of ready cash may be avoided. Also, prompt payment discounts should not be overlooked.

By carefully checking work-in-process, the entrepreneur may find that some of it can be brought to completion and sold ahead of schedule. If this speed-up is economical, he can quickly pump ready cash into his firm.

He may be able to ship out more orders faster than anticipated by significantly increasing production. By also using messenger service and shipment via air express, he may be able to cut down the in-transit time of the finished products and further speed the day of payment.

By consolidating scattered accounts in one bank, he may cut down on services charged for below-minimum-amount accounts, or reduce the idle minimum amounts (kept in bank accounts to avoid service charges), thus freeing funds for his operations or for investments.

He may be able to reduce the tax liability and, by the same token, improve his cash position, by bringing about changes in his depreciation schedule and inventory accounting.

The next problem is to tighten-up external relationships. Here, care should be given to the following three items:

1. Terms of trade
2. Collections schedules
3. Payment methods

The businessman may be able to persuade his customers to agree to a speedier payment after his delivery of merchandise.

He may be able to make an agreement with his major supplier of suppliers which will allow him to stretch out his payment schedule, so that he can always keep a certain level of cash on hand.

When the payment schedule is stretched out because of an agreement with a supplier, what is being obtained is trade credit. This trade credit is an important source of financing for small firms. A survey of small business has reported that, "Twenty-two percent of the firms in the sample used such credit,"[1] i.e., trade credit.

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[1] Finn, Gene L., "Small Business Experiences in Seeking Credit," Management Research Summary, Small Business Administration, December, 1962.

To augment the amount of ready cash, the businessman may also be able to arrange for earlier payments due from his larger customers.

He may be able to make use of rapid transfer arrangements of deposits from one area of the country to another through payment plans available through many banking houses. These rapid transfers will result in a saving of time, since there is an immediate credit deposit at the central banking facility.

If the businessman can get an agreement from his customers that they will pay for express or freight shipments (F.O.B.), the outflow of funds will be kept down.

If he can ship much of his merchandise COD, he can collect many of his bills quickly.

Progressive billing, or billing for completed portions of an order, may be an arrangement acceptable to customers, as might be the "pre-sale" of future production. Under the latter arrangement, a customer, in effect, finances that part of future production which is destined for him.

When the entrepreneur divests himself of fringe assets he will be trying to decide which assets do not relate directly to his operations, and which he does not need to carry on his business. In this case, selling these assets will probably be of greater advantage to him than retaining them. He may find fringe assets within the following groups of assets:

1. Equipment
2. Buildings and real estate
3. Securities

There may be some equipment in his plant which is of no immediate use. To get ready cash now, he may want to consider selling it.

The entrepreneur may want to review some of the physical assets currently owned by his business. For instance, there may be part of his physical plant he can safely dispense with. Some acreage, perhaps, for which he once thought he might have some use, but for which he has so far found no use, might be sold. There may be a building which has long stood idle and which he is not including in any physical expansion plans. Or, perhaps, he bought some property which does not even form part of his operations, and which, to obtain cash, he could sell. Again, he may feel that there is no real reason for him to own the building which his firm currently occupies. He may prefer having cash instead of that property. If this is the case, he may be able to work out a sale-and-lease-back arrangement. In other words, he sells the property, and the new owner gives him a lease for the space his firm now occupies.

As for securities, the businessman might want to consider selling some of the marketable securities he own, such as stocks or bonds. Marketable securities, of course, also can be used as loan collateral.

Lastly, the small businessman should be aware of the other ways of providing capital as described in this chapter because he may, on occasion, have the ordinary methods denied to him. Actually, the number of firms which have non-recourse to banks is amazingly high, considering the plentiful supply of banks. A survey of small businesses shows 34.0 percent of manufacturing firms, 39.7 percent of non-manufacturing firms, and 36.8 percent of all firms, claimed bank credit was not available to them, for one reason or another.[2]

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[2]Jackendoff, Nathaniel, "Financial Analysis and Small Business," Management Research Summary, Small Business Administration, May, 1961.

CHAPTER III

FEDERAL GOVERNMENT LOAN SOURCES

The problem of obtaining financing is of prime importance to operators of small businesses. It may mean the difference between continued solvency and eventual bankruptcy.

The most important source of loans other than bank loans is the federal government. Many businessmen do not realize that there are numerous federal agencies authorized to make, or to guarantee, or to insure loans.

Generally speaking, to be eligible for a government loan, certain fundamental requirements must be met. These requirements are:

1. Financing from private, commercial sources must not be available on reasonable terms.

2. There must be reasonable assurance of repayment of the loan.

3. The loan must be in the public interest.

Because of the great complexity of federal government loans, no attempt will be made here to set out in full all of the details and requirements of the various government loan programs. Further, this discourse is not intended to be a complete compilation of government loan sources. Only those loan sources which are believed to be of major interest to the small business owner are described.

Basically, there are four loan sources in the federal government for small businesses. They are as follows:

1. Small Business Administration
2. Treasury Department
3. Federal Reserve System
4. Federal Home Loan Banks

Small Business Administration

The most important loan source of the federal government is the Small Business Administration (SBA). The business loan program of the SBA is expressly designed to assist small enterprises--manufacturers, wholesalers, retailers, service establishments, and other businesses--which are independently owned and operated and not dominat in their fields. The SBA's business loans enable small business concerns to finance construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies or materials; and to acquire working capital.

Generally, the SBA loan program is designed for small businesses that are unable to obtain from private sources the intermediate and long-term credit required for general purposes and normal growth. In addition to the fundamental requirements for government loans previously outlined, an applicant for an SBA loan must also meet these other requisites:

1. The applicant must be of good character.

2. He must show evidence of ability to operate his business successfully.

3. He must have enough capital in the business so that with the SBA loan it will be possible to operate on a sound financial basis.

4. On a long-term loan (one repayable in installments over a period of several years), the past record and future prospects of the business must show sufficient probable future income to provide reasonable assurance of repayment. It is necessary that the loan be adequately secured by real estate, chattel mortgages, or other suitable collateral.

The SBA offers the following types of business loans to small businesses:

1. Bank participation loans
2. Direct loans
3. Disaster loans
4. Loans Under the SBA Investment Act of 1958, as amended

<u>Bank participation loans</u>.--Through its bank participation plan, SBA cooperates with private lending institutions in meeting the credit needs of small firms. Often, a bank is willing to make a loan to a small firm if the SBA participates in it, i.e., purchases (immediate participation) or agrees to purchase on demand (deferred participation) a share of it. The SBA may participate in up to 90 percent of the amount of the loan. This participation may be immediate or deferred, as the

bank may elect. The agency cannot enter into an immediate participation, however, if a deferred participation is available.

In an immediate participation loan, the agency purchases immediately from a bank, or sells to a bank, a certain percentage of a loan which has been approved by both it and the bank. The loan may be serviced either by the bank or by the SBA.

In the case of a loan in which the agency agrees to participate on a deferred basis, the participating financial institution makes and administeres the entire loan, with the SBA agreeing to purchase from the bank, at any time during a stated period, a fixed percentage of the then outstanding balance.

These loans generally are repayable in regular installments, usually monthly, including principal and interest. Interest is charged only on the actual amount borrowed, and for the actual time the money is outstanding. All or part of the loan may be repaid without penalty before it is due.

The maximum interest rate on SBA;s share of the loan is 5½ percent per annum. A private lending institution may set a higher rate than this on its share of the loan, however.

The maximum maturity of an SBA loan is 10 years and the maximum amount of the SBA share to any one borrower is $350,000.

Direct loans.--Where a private lending institution will not make the full loan and will not participate, SBA may make a direct loan. Terms for direct loans, including repayment, maturity, interest, and amount, are the same as for bank participation loans.

Disaster loans.--This type of loan is made to individuals, business concerns, and nonprofit organizations such as churches and charitable institutions, to repair and rebuild homes and businesses, which have suffered physical damage from floods, tornadoes, hurricanes, and similar catastrophes.

There is no limit on the amount of an SBA disaster loan. These loans generally are to be repaid in equal monthly installments, including interest, usually beginning not later than 5 months after the date of the note. The final maturity of a loan is based on the borrower's ability to repay, but by law may not exceed 20 years. The interest rate on the disaster loan is 3 percent.

Loans Under the SBA Investment Act of 1958, as amended.--This act provided for the lending of funds to development companies and small business investment companies. These companies in turn make loans to small businesses in their area. The interest rate is usually 5 percent, and the amount is limited to $250,000.

Treasury Department

Loans under Section 302 of the Defense Production Act for materials and services for national defense can be made upon certificate of essentiallity issued by the Director of the Office of Civil and Defense Mobilization.

Federal Reserve System

The principal loan function of the Federal Reserve Bank is to extend credit to member banks; however, the Reserve Banks also act as fiscal agents under the Board's Regulation V and the Defense Production Act of 1950 in a loan guarantee program to expedite defense contracts.

Loans are actually made by private banks, with a designated portion guaranteed by the procurement agency most concerned. The guaranteed portion can run up to 100 percent. The fee is based on a sliding scale, making it advantageous to request as small a guarantee as possible.

Federal Home Loan Banks

Under the supervision of the Home Loan Bank Board, eleven district Federal Home-Loan Banks fulfill the reserve credit needs of some 4,600 member savings and loan associations and cooperative banks. The funds of these district banks come largely from their capital, the sale of obligations in the market, and deposits of excess cash of their members. The district banks lend only to their member institutions to meet the seasonal and emergency credit requirements of these institutions and to maintain an adequate flow of loan funds in every state.

Long-term loans (up to ten years) of member institutions are secured by either mortgages or bonds. Short-term loans for periods up to one year may be so secured or simply not secured at all. Interest rates vary.

In conclusion, it is surprising that such a large percentage of small businessmen are not cognizant of the many federal agencies that are able to assist them financially. A recent study of small-firm businessmen reported, "Many did not know what sources of capital, other than banks, were available."[1]

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[1]Stevenson, Harold W., "Sources of Equity and Long-Term Financing for Small Manufacturing Firms," Management Research Summary, Small Business Administration, June, 1962.

CHAPTER IV

LENDER INFORMATION REQUIREMENTS

Loans are by far the most popular form of financing. It would seem to follow then, that one of the first things a businessman would want to know is what are the lender requirements. This chapter will examine the financial facts, etc., which lenders require.

The question that is uppermost in the minds of lending officers of banks and other financial institutions considering a loan to a small company, quite naturally is this--"can the company repay the loan?" To answer this question the lending officers have determined that certain kinds of information about the small company which is asking for the loan, are needed.

Most lenders require information about the following financial data:

1. Business Collateral
2. Audited Financial Statements
3. Sales and Cash Projections
4. Operating and Financial Ratios
5. Business Operations During Loan

Business Collateral

When the entrepreneur secures a loan with business collateral such as accounts receivable, inventories, or fixed assets, the lender needs to know about the condition of that business collateral. In certain cases, he will send his representative directly to the entrepreneur's plant to get such information.

The lender's representative will look for various facts when he visits a plant. These will include, but are not necessarily limited to:

1. General information about the company
2. The condition of accounts receivable
3. The condition of the inventories
4. The condition of the fixed assets

Some of the general information which he looks for is as follows:

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

On accounts receivable, the lender's representative wants to know:

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? The representative will check the condition of the largest accounts. How much do these customers owe and what percentage of the total accounts does this amount represent?

The representative will want to know the following about inventories:

Is merchandise in good shape or will it have to be marked down" How 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 the inventory turn-over in line with the turnover for the industry? Is money being tied up too long in inventory?

Concerning fixed assets, the lender's representative is interested in:

The type, age, and condition of equipment and machinery, the depreciation policies, the details of mortgages or conditional sales contracts, and future acquisition plans.

Audited Financial Statements

A financial statement that has been audited by a public accountant is one of the most important tools which the lender uses in considering a loan application. The audited statement is furnished by the borrower. This means that the owner-manager has to pay a public accountant to examine his financial statements and prepare an auditor's report for the lending officer's use.

The audit fee will be according to the time spent on the job, so it would behoove the owner-manager to make sure that the auditor does not have to do detail work of which his own bookkeeper is capable.

Some examples of the detailed preparation which the bookkeeper, or accountant, can accomplish before the auditor arrives are:

1. Balance the general ledger and insure that all ledgers agree with the control accounts
2. Reconcile the bank accounts
3. Analyze the income and expense accounts

The owner-manager should also be ready for the physical inventory which the auditor will want to observe. Those personnel concerned should be instructed ahead of time on the proper methods of taking and pricing the inventory.

As was previously mentioned, a properly audited financial statement is a most important tool of the lender. Bank officers have been known to grant loans on the basis of financial statements even when the statements showed a loss. On the other hand, they are usually hesitant about granting a loan on the basis of an unaudited statement even when it shows a profit.

Sales and Cash Projections

The lending officer gets an idea about the amount of cash the owner-manager expects to take in by looking at his cash forecast.

A cash forecast is a plan, or estimate, in statement form. It shows:

1. How much cash one expects to receive
2. How much one expects to have on hand at the end of a certain period.

3. How much cash one expects to have on hand at the end of a certain period.

The period referred to above will usually be for a year with detail given on a month-by-month basis.

The accuracy of a cash forecast depends, to a great extent, on the owner-manager's estimate of future sales.

Other information the lending officer can obtain from cash forecast statements, according to a recent study,[1] is as follows: (1) Is there overinvestment in inventory or capital equipment which might threaten a safe cash position? (2) Is there excess cash on hand that should be used for expanding the company? (3) Are expenses excessive?

A cash forecast can be worked out by adding to the expected cash balance at the beginning of each month, all the cash receipts which are expected. Then from this total, all the cash disbursements which he expects to make, are subtracted.

Operating and Financial Ratios

Supplying the lending officer with ratios for the company can help him in making a judgement on the loan application. These ratios enable him to pinpoint the strong and the weak spots in the financial operation.

The seven most commonly used ratios are the following:

1. Current ratio
2. Quick ratio
3. Accounts receivable turnover ratio

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[1]Price, Selwin E., "Financial Facts Which Lenders Require," Managements Aids for Small Manufacturers, Small Business Administration, May, 1964.

4. Inventory turnover ratio
5. Net worth to total debt ratio
6. Book value per share ratio
7. Expense to sales ratio

Some lenders also use other ratios which have been developed as aids for determining whether a loan is safe. It is important to realize that ratios vary from industry to industry because each industry has its own peculiarities. The lender wants to see how the ratios of a particular firm compare with those for the industry.

Business Operations During Loan

After the owner-manager has borrowed the money, the lender needs to know how his company is progressing while he still is in debt. The long-term loan requires more facts and figures than short-term borrowing. The lender gets this information from data which the accountant or bookkeeper supplies.

The lender may want copies of any or all of the following reports and statements:

1. Balance sheet
2. Income statement
3. Statement of retained earnings
4. Source and application of funds statement

The lender will require these reports and statements periodically. How often depends on the time length of the loan.

As a rule, such interim financial statements must be signed by you the owner-manager or one of the company's officers.

This signature shows the lender who is responsible for the contents of the reports.

These interim statements can be simple, and even brief. The important thing is that they be accurate.

Sometimes lenders also ask for other financial data, such as the following:

1. Sales of major products
2. Profit margins per product
3. A list of major customers
4. An aged listing of accounts receivable

Often the lender wants such information on a comparative basis. For example, he might want information as of July 1 for the past 3 years. The lender will use such information to determine trends in the business.

CHAPTER V

FINANCING PROBLEMS

When providing capital or securing additional funds for his business, the owner-manager may be aware of the different methods of obtaining this financing, and he may know all about where and how to obtain them. What he may not know about, however, is the nature of some of the troublesome problems that can arise, and how to avoid them.

As previously mentioned, if he is cognizant of these potential problem areas, he may then attempt to guide the financing efforts of his business around them, in effe side-step them.

The possible problem areas for small business fin that seem to be most prevalent, and yet that owner-man are least aware of, fall into the following three area

1. Low Net Worth
2. Loan Eligibility
3. Effect of Tight Money

Low Net Worth

A recent study has shown that the low net worth of small firms is a financing problem.[1] Why is the net worth so low

[1] Friedland, Seymour, "Financing Problems of Small Manufacturers," Management Research Summary, Small Business Administration, November, 1962.

for a small firm? The answer to this question is found in an analysis of retained earnings. The study indicated that retained earnings for the small firm is less than 20 percent of total assets, which compares unfavorably with 38 percent of total assets for firms in general. The study also indicated that firms lean too heavily on debt funds for financing, as a rule.

Retained earnings, in turn, are dependent upon (1) profits earned, and (2) dividends paid. Small businesses tend to retain a higher percentage of earnings than large businesses. In 1958, for example, the above referenced study showed that United States manufacturing firms of all sizes averaged dividends amounting to almost 60 percent of earnings, while firms with assets of less than $250,000 paid out only 30 percent of earnings.

On the other hand, small businesses earned only about 8 percent on net worth that year, as compared to approximately 16 percent for all manufacturers. Thus, it is clearly evident that the difference between large and small firms in the relative importance of retained earnings is the result of lower profitability in the small firms and not a high rate of dividend payment.

Another effect of those low profits is that it restricts the ability of the small firms to obtain funds through equity capital investment. A small business cannot attract high profitability and rapid growth.

Thus, it seems to be a vicious circle. Firms of low net worth (according to the study) tend to have low profits, low profits limit a firm's ability to secure funds, and without funds a firm is certainly going to be of low net worth or at least heading in that direction.

Loan Eligibility

Another problem facing the small businessman is that of eligibility. The Small Business Administration is an excellent and frequently used source of funds for the small firm. However, there are some rather stringent restrictions placed on the borrower concerning his eligibility, when he borrows from this source. If he knows about these eligibility restrictions and meets the requirements, he may be able to secure a very advantageous loan, and by so doing be that much ahead of his competitor, who does not know of these restrictions. Some of the most important of these eligibility restrictions are outlined in the next few paragraphs.

Loans cannot be made to business if the business can obtain money on reasonable terms:

1. From a financial concern;

2. By selling assets it does not need;

3. By the owner's using, without undue hardship, his personal credit or resources of his partners or principal stockholders;

4. By selling part of the ownership in the company through a public offering or a private placing of any of various kinds of securities;

5. From other government agencies which provide credit specifically for the borrower's type of business of for purpose of the required financing.

Also, loans cannot be made if the purpose or result of granting the loan would be to:

1. Pay off a creditor or creditors of the applicant who are inadequately secured;

2. Provide funds to distribute or pay to the owner, partners, or shareholders;

3. Replenish working capital funds previously used to pay the owner, partners, or shareholders;

Finally, loans cannot be made to applicants if:

1. The loan would provide or free funds for speculation in any kind of property;

2. The loan would be used to relocate a firm for other than sound business purposes;

3. The purpose of the loan is to finance the acquisition, construction, improvement, or operation of real property that is held primarily for sale or investment;

4. The applicant's purpose in applying for a loan is to effect a change in ownership of the business;

5. The effect of granting of the financial assistance will be to encourage monopoly.

Effect of Tight Money

When money is tight, discrimination against small businesses may assume two forms. Banks may decrease the flow of loanable funds to small businesses in order to maintain or expand the flow to larger concerns. They also may raise interest rates proprotionately more on small-business than on large-business loans.

A study has found that on long-term loans to the textiles, leather, and apparel industries, interest rates that were charged to small firms more than doubled in the 1955-1957 tight-money period, while rates that were charged to the large firms increased only moderately.[2]

Disproportionate increases also occurred in other manufacturing areas. Short-term rates increased more for large than for small businesses, but only slightly so.

The relative demand for loans within the respective industries cannot account for these differences. In several cases, remarkable increases in long-term rates charged to small businesses were accompanied by very small increases in volume. At the same time, large increases in loan volume to large businesses were accompanied by modest increases in the long-term rate of interest.

It would seem that the more inelastic the demand for loans, the larger the price that can be charged. Of course, when loanable funds are in short supply, rationing will lead to larger rate increases for small firms which are heavily dependent on commercial banks, than for larger firms, which have more alternative sources of funds.

The study also found that during the years 1946-1955, small manufacturing concerns expanded member bank borrowing

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[2]Carson, Deane, "The Effect of Tight Money on Small Business Financing," Management Research Summary, Small Business Administration, July, 1963.

by considerably greater amounts than large firms. However, in the tight-money period of 1955-1957, small manufacturer borrowing increased very little, not only absolutely, but in comparison to both their own borrowing in the earlier period and the loan expansion of large manufacturers.

Further, the study found that, surprisingly, all too few small businesses avail themselves of long-term credit using other than bank sources. It was found that relatively few firms had tried to obtain equity capital. Of the firms that had tried, those whose assets were below $1,000,000 were much less successful than larger firms.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS

A considerable number of small firms rely too heavily on debt funds for financing. This probably contributes to their lack of growth, and helps keep them in the "low net worth" category of businesses.

It is suggested that some of the resources (particularly the federal) available for solving small firm finance problems be diverted from supplying more debt funds to aid in the solution of the problem of low profitability.

Specifically, the following three areas are recommended for special consideration:

1. Education of small-firm managers in techniques of finance acquisition and finance management;

2. Evaluation of the various management finance tools to ascertain if the small businessman is correctly using them;

3. Evaluation of the effects of business concentration and monopoly on small business financing.

With reference to the rather restrictive requirements concerning eligibility applied by the Small Business Administration in making their loans available, the only course to be recommended is that the interested small businessman should thoroughly investigate the specific requirements in his case to see whether he is eligible or not, for a loan.

The loans that the Small Business Administration grants, even though the restrictions are quite stringent, are generally the best that can be had. They are usually at lower rates, and better terms of agreement may be made under these loans than from any others available. So, it would behoove the interested small-business manager to carefully check with the Small Business Administration office closest to him first, and only revert to other sources for financing when this source is denied him.

As to the effect of tight money, supply discrimination implies that lenders turn down good small-firm borrowers in order to allocate a larger volume of funds to good large-firms borrowers. If the implication that tight-money policies lead to discrimination against small businesses is to be tested adequately, it would seem that further data are required to avoid the questionable assumption that the flow of loans adequately measures demand.

Finally, the apparent failure of small businesses to fully exploit sources other than banks for long-term credit, indicates the following conclusion. If subsequent tests prove that banks do discriminate against small businesses in the flow and cost of credit, the discrimination might be lessened by a program of financial education for small-business owners.

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