The Credit Process: A Guide for Small Business Owners

Table of Contents

Introduction

Some say owning a home is the American dream. Millions of small business owners will argue, however, that owning one's own business is really the American dream.

But while it offers rewards, owning a business is not easy. Entrepreneurship has its problems, and a critical—and sometimes fatal—one for small businesses can be the lack of access to the financial resources to keep the dream going.

The purpose of this booklet is to assist small business owners or entrepreneurs who are seeking outside financing for the first time. Our goal is to highlight information that prospective borrowers need to know about the credit process before they apply for a loan.

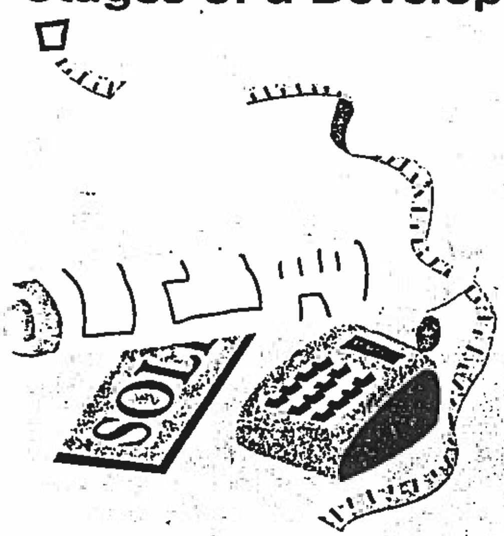
Sources and Types of Funding

Where to Borrow

Getting credit for a business can be a dilemma because until you've developed a good track record with business credit, many commercial banks and other traditional lenders will be reluctant to extend credit to you.

In order to identify the type of financial institution most likely to lend to your business, it's helpful to pinpoint which of the four early stages of development your business is in.

Stages of a Developing Business



Stage one businesses are start-ups.

Stage two businesses have business plans and product samples but no revenues.

Stage three businesses have full business plans and pilot programs in place.

Stage four businesses have been in operation for some time and have documented revenues and expenses.

Lenders suggest that rather than approaching a bank, owners of businesses in stages one and two should seek financing from informal investors. Such sources of funding may include friends or relatives, partners, local development corporations, state and local governments offering low-interest micro loans, private foundations offering program-related investments, credit unions featuring small business lending, and universities with targeted research and development funds.

Lenders say that businesses in stage four, and some in stage three, are sufficiently developed to approach a commercial bank or another traditional lender for a loan.

If your business is in stage three or four and you intend to approach a commercial bank, lenders suggest that you first submit an application to a bank with which you have an established relationship. If you do not have an established relationship with a bank, lenders recommend that you ask an experienced accountant or lawyer to contact a bank and present your proposal.

Also, keep in mind that you must choose a legal designation—sole proprietorship, partnership, or corporation—and execute the necessary documentation for your small business before approaching a bank or another lender.

Reason to Borrow

There are three major reasons why businesses borrow; the first and most common reason is to purchase assets. A loan to acquire assets could be for buying short-term, or current, assets—such as inventory—and would be repaid once the new inventory is converted into cash as it is sold to customers. Or, the funds could be for the addition of long-term, or fixed, assets, such as equipment.

The second reason is to replace other types of credit. For example, if your business is already up and running, it may be time to take out a bank loan to repay the money you borrowed from a relative. Or, you may wish to use the funds to pay suppliers more promptly to get a discount on the price of the merchandise.

The third reason is to replace equity. If you wish to buy a partner's share in your business but you don't have the cash to do it, you may consider borrowing.

Loan Types

The purpose of your loan is critical in determining the type of loan you request. You also should make sure that the timing of the repayment schedule on your loan matches the incoming cash flow you will use to make the payments.

There are a number of loan types available to commercial borrowers, including lines of credit, seasonal commercial loans, installment loans, collateralized loans (which are secured with assets), credit card advances, and term loans. Regardless of the type, most loans have the following features:

Common Loan Features

- Loans are long term or short term.
- Interest rates vary depending on the term, type, size, and risk of the loan.
- Repayment may be a lump sum or on a monthly or quarterly schedule.
- Payments may be delayed until the funds help your business generate cash flow.
- The loan may be committed, meaning the bank agrees to lend to you under certain terms as you need funds without requiring you to re-apply each time.
- Some loans require that you maintain compensating balance levels in a deposit account.

Loan Agreements

You also should be aware that the lender will expect you to agree to certain performance standards and restrictions in order to ensure that your business can repay the loan. These restrictions, known as covenants, representations, and warranties, commonly include the following:

Common Loan Restrictions

- Maintenance of accurate records and financial statements
- Limits on total debt
- Restrictions on dividends or other payments to owners and/or investors
- Restrictions on additional capital expenditures
- Restrictions on sale of fixed assets
- Performance standards on financial ratios
- Current tax and insurance payments

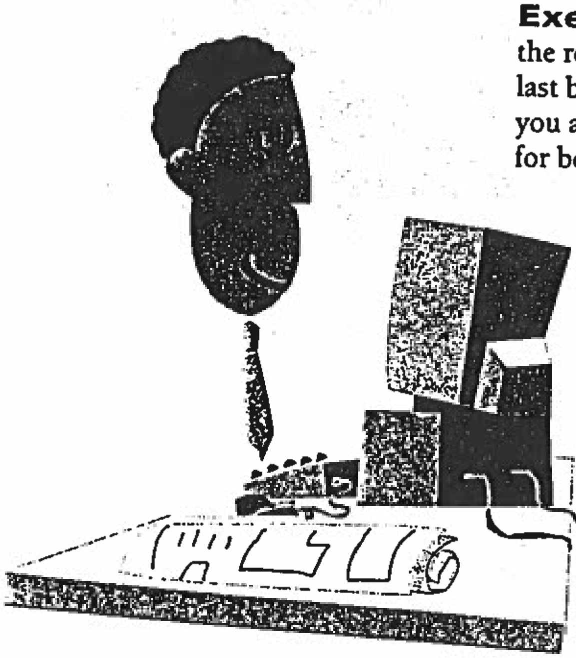
This page intentionally left blank

The First Step: Preparing Your Business Plan and Loan Request

When you apply for a business loan, you will need to provide certain information about yourself and your business in the form of a business plan. A business plan can act as an ongoing management guide to help you establish production goals and measure actual performance. Your business plan can help demonstrate to a prospective lender that you have the knowledge, managerial competence, and technical capability to run a successful business.

The plan must be thorough and well organized. The finished document should be typed and placed in a binder. Make several copies for each of your prospective lenders and keep several copies for your files. Lenders recommend that you prepare the plan with the help of your accountant or a professional at a small business development center. Resources to assist you in writing your business plan and loan request are listed in the Information Guide in the back pocket of this booklet.

The Business Plan



The business plan should include the following sections:

Title page. List the name of the business, the owner(s), the address, and telephone and fax numbers.

Executive summary. Provide a brief summary of the plan and tell the reader how it is organized. The executive summary should be written last because it will draw on the other parts of the business plan. It tells who you are, the function of the company, and gives a summary of your purpose for borrowing.

Company description. Give an overview of the function and history of your company, its size, products or services, and markets.

Market analysis. Present your research and a discussion of the conditions and trends within the industry. Review the market for your product and the demand for it. Describe how many major competitors you have, how much of the market each of your competitors controls, and your strategy for gaining a share of the market or developing a new niche. You should be able to explain any barriers to entry into new markets you are considering and how you plan to overcome them.

demonstrate that you [illegible] and the [illegible] you [illegible]

Products and services. Explain your product or service and its function.

Operations. Explain how you make your product or provide your service. Specify how you get your product out the door to the customer. Where will you get your raw materials or inventory? If a manufacturing process is involved, describe it here, including the size of the factory, stages of production, and work flow. Or, if you have a retail business, give the location of your store. How was the site selected? Where will inventory be warehoused?

Marketing plan. Describe how you intend to sell your product or service and who will buy it. Also, discuss your distribution plans, advertising arrangements, and sales force.

Ownership. Indicate what type of legal entity your company is and its ownership structure: sole proprietorship, partnership, or corporation. If you have partners, who are they? How much of your company do they own? Describe how these individuals became principals and what you have agreed to give them in return for their investments.

Management and personnel. Review who is in charge, who works for you, and why you hired them. Describe how their experience will contribute to the success of your business. Include resumes of key people, including yourself.

Funds required and expected use. Summarize why you need a loan and how you will use the money. Ask for a specific amount. Include documentation on collateral, guarantor agreements, and signed contracts. Describe your repayment plan and present a contingency plan should your initial source of repayment fail.

Financial statements and projections. Include a personal financial statement, personal tax returns, and business financial statements—balance sheet, profit and loss statement, cash flow analysis for the last three to five years (if you have been in business that long), and projections for the expected performance of your business for the upcoming three-year period.

show that a loan/line is needed.

In this section you will need to demonstrate your understanding of basic accounting and the financial concepts that are crucial to the success of your business. By using complete and correct financial statements, you will be able to communicate to a prospective lender how these concepts are successfully applied in your business.

(An overview of the financial statements you need and how a prospective lender will analyze them appears in the next section of this booklet entitled "What the Lender Will Review.")

Appendices/exhibits. This section should document any issues that can't be addressed in the text. For example, distribution agreements, contracts for the purchase of your product, and your operating licenses would all be included as appendices.

What the Lender Will Review

Credit Analysis

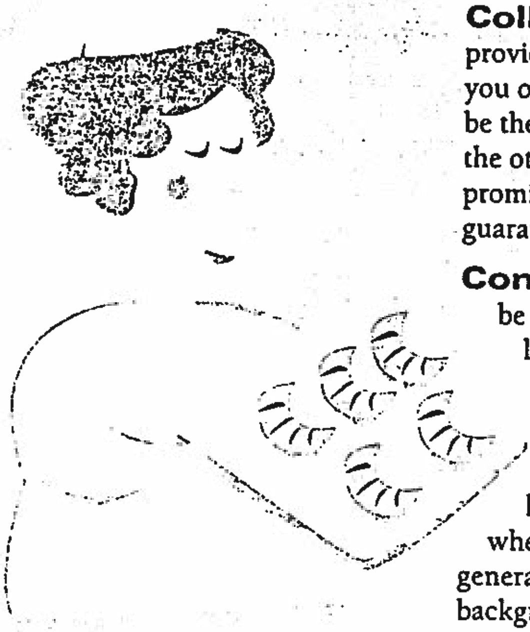
Regardless of where you seek funding—from a bank, a local development corporation, or a relative—a prospective lender will review your creditworthiness. A complete and thoroughly documented loan request (including a business plan) will help the lender understand you and your business. The basic components of credit analysis, the "Five C's," are described below to help you understand what the lender will look for.

The "Five C's" of Credit Analysis

If answer to this question is no, then no need to proceed

Capacity to repay is the most critical of the five factors. The prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan. Payment history on existing credit relationships—personal or commercial—is considered an indicator of future payment performance. Prospective lenders also will want to know about your contingent sources of repayment.

Capital is the money you personally have invested in the business and is an indication of how much you have at risk should the business fail. Prospective lenders and investors will expect you to have contributed from your own assets and to have undertaken personal financial risk to establish the business before asking them to commit any funding.



Collateral or guarantees are additional forms of security you can provide the lender. Giving a lender collateral means that you pledge an asset you own, such as your home, to the lender with the agreement that it will be the repayment source in case you can't repay the loan. A guarantee, on the other hand, is just that—someone else signs a guarantee document promising to repay the loan if you can't. Some lenders may require such a guarantee in addition to collateral as security for a loan.

personal guarantee required

Conditions focus on the intended purpose of the loan. Will the money be used for working capital, additional equipment, or inventory? The lender also will consider the local economic climate and conditions both within your industry and in other industries that could affect your business.

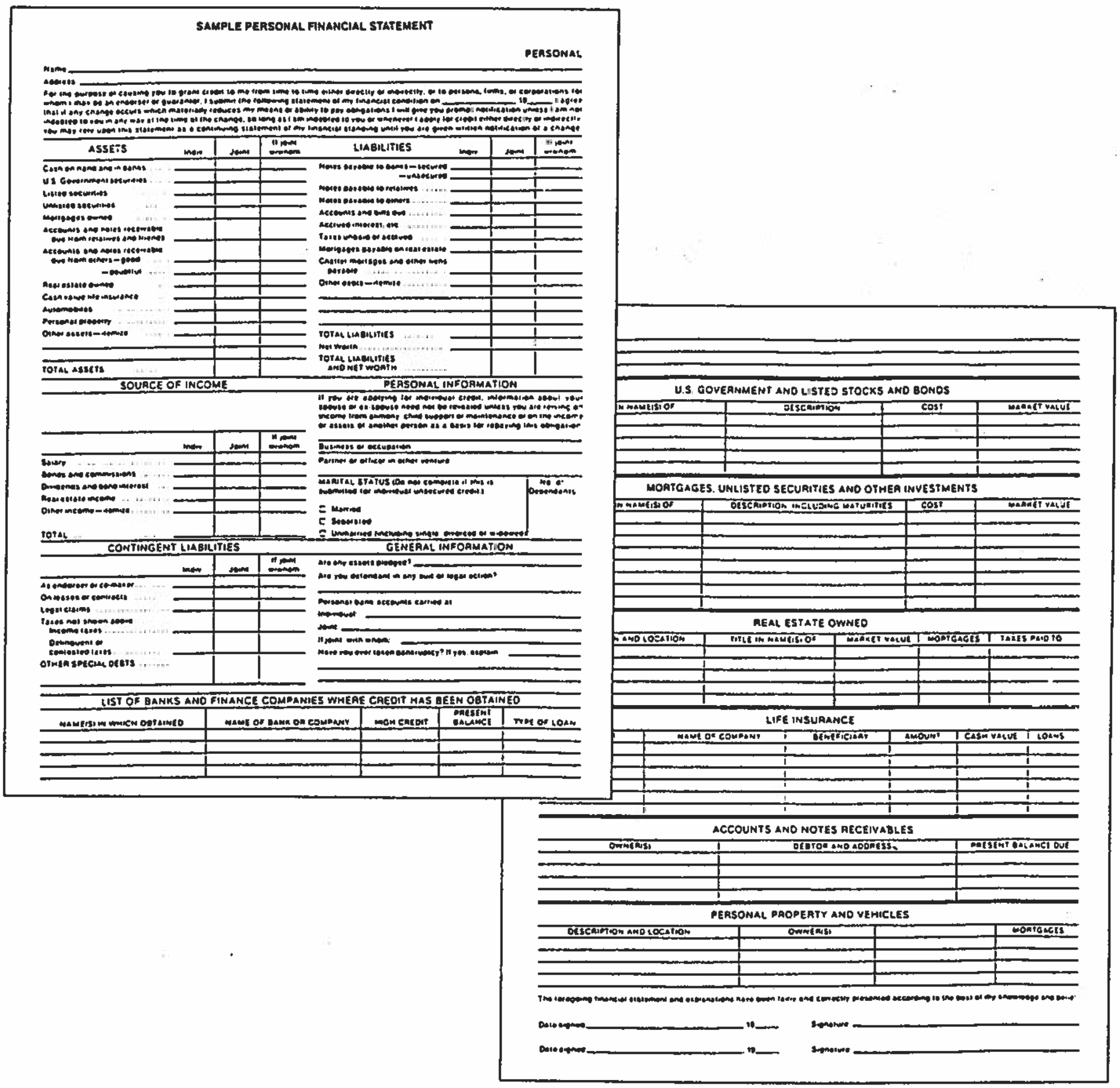
Character is the general impression you make on the potential lender or investor. The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your company. Your educational background and experience in business and in your industry will be reviewed. The quality of your references and the background and experience levels of your employees also will be taken into consideration.

personal credit bureau

In addition to the "Five C's," a prospective lender will use four primary financial statements to make a credit decision.

A Personal Financial Statement:

Indicates your net worth. Each partner or stockholder owning a substantial percentage (for example, 20 percent or more) of the business should submit one. A personal financial statement is important to the lender, particularly if you have never received financing for your business before, because it gives the lender evidence of personal assets you could pledge to secure a loan. A sample personal financial statement is shown here.



SAMPLE PERSONAL FINANCIAL STATEMENT

PERSONAL

ASSETS	Indiv.	Joint	If joint whom	LIABILITIES	Indiv.	Joint	If joint whom
Cash on hand and in banks				Notes payable to banks—secured			
U.S. Government securities				—unsecured			
Listed securities				Notes payable to relatives			
Unlisted securities				Notes payable to others			
Mortgages owned				Accounts and bills due			
Accounts and notes receivable due from relatives and friends				Accrued interest, etc.			
Accounts and notes receivable due from others—good				Taxes unpaid or accrued			
—doubtful				Mortgages payable on real estate			
Real estate owned				Chattel mortgages and other liens payable			
Cash value life insurance				Other debts—itemize			
Automobiles							
Personal property							
Other assets—itemize				TOTAL LIABILITIES			
				Net Worth			
TOTAL ASSETS				TOTAL LIABILITIES AND NET WORTH			

SOURCE OF INCOME

	Indiv.	Joint	If joint whom
Salary			
Bonus and commissions			
Dividends and bond interest			
Real estate income			
Other income—itemize			
TOTAL			

PERSONAL INFORMATION

Business or occupation

Partner or officer in other venture

MARITAL STATUS

No. of Dependents

☐ Married

☐ Separated

☐ Unmarried (including single, divorced or widowed)

CONTINGENT LIABILITIES

	Indiv.	Joint	If joint whom
As endorser or co-maker			
On leases or contracts			
Legal claims			
Taxes not shown above			
Income taxes			
Delinquent or contested taxes			
OTHER SPECIAL DEBTS			

GENERAL INFORMATION

Are any assets pledged?

Are you defendant in any suit or legal action?

Personal bank accounts carried at

Individual

Joint

If joint, with whom

Have you ever taken bankruptcy? If yes, explain

LIST OF BANKS AND FINANCE COMPANIES WHERE CREDIT HAS BEEN OBTAINED

NAME(S) IN WHICH OBTAINED	NAME OF BANK OR COMPANY	HIGH CREDIT	PRESENT BALANCE	TYPE OF LOAN

U.S. GOVERNMENT AND LISTED STOCKS AND BONDS

IN NAME(S) OF	DESCRIPTION	COST	MARKET VALUE

MORTGAGES, UNLISTED SECURITIES AND OTHER INVESTMENTS

IN NAME(S) OF	DESCRIPTION INCLUDING MATURITIES	COST	MARKET VALUE

REAL ESTATE OWNED

AND LOCATION	TITLE IN NAME(S) OF	MARKET VALUE	MORTGAGES	TAXES PAID TO

LIFE INSURANCE

	NAME OF COMPANY	BENEFICIARY	AMOUNT	CASH VALUE	LOANS

ACCOUNTS AND NOTES RECEIVABLES

OWNER(S)	DEBTOR AND ADDRESS	PRESENT BALANCE DUE

PERSONAL PROPERTY AND VEHICLES

DESCRIPTION AND LOCATION	OWNER(S)		MORTGAGES

Date signed ____ 19__ Signature ____

Date signed ____ 19__ Signature ____

A Balance Sheet

Provides you with a snapshot of your business at a specific time, such as the end of the year. It keeps track of your company's assets, or what the company owns (including its cash), and the company's debts, or liabilities (generally loans from others). It also shows the capital, or equity, put into the business. This balance sheet is an example of a statement for a small, hypothetical food manufacturer called F.E.D. Foods Company.

F.E.D. Foods Co. Balance Sheet

As of December 31,	1993		1992	
	($ Thousands)			
Assets				
Current Assets				
1. Cash	$ 3	} 11	$ 2	} 14
2. Marketable Securities	8		12	
3. Accounts Receivable	42		33	
4. Inventories	157		150	
5. Prepaid Expenses	2		3	
6. Total Current Assets	212		200	
7. Plant, Property, and Equipment	1,067		983	
8. Less Accumulated Depreciation	450		417	
9. Net PPE	617		566	
10. Investments	267		217	50
11. Other Assets	16		17	
12. Total Assets	1,112		1,000	
Liabilities				
Current Liabilities				
13. Accounts Payable	38		42	
14. Notes Payable	80		66	Taxes Payable break out separately to show that taxes are being [illegible] properly.
15. Total Current Liabilities	118		108	
16. Long-Term Debt	0		0	
17. Deferred Tax Liability	77		67	Timing Difference
18. Total Liabilities	195		175	
Capital				
19. Common Stock	367		327	
20. Retained Earnings	550		498	
21. Total Liabilities and Capital	1,112		1,000	

A Profit and Loss Statement

Shows the profit or loss for the year. The profit and loss statement, also called the income statement, takes the sales for the business, subtracts the costs of goods sold, then subtracts other expenses. This is a profit and loss statement for F.E.D. Foods Company.

F.E.D. Foods Co.
Profit and Loss Statement (Income Statement)

Years Ended December 31,	1993	1992
	($ Thousands)	
a. Net Sales	$ 633	$ 500
b. Cost of Goods Sold	358	300
c. Gross Profit	275	200
d. Selling and Administrative Expenses	27	20
e. Lease Payments	17	12
f. Depreciation	50	42
g. Repairs and Maintenance	17	18
h. Operating Profit	164	108
Other Income (Expense)		
i. Interest Income	3	1
j. Interest Expense	0	0
k. Earnings Before Income Taxes	167	109
l. Income Taxes	57	37
m. Net Earnings	110	72

A Statement of Cash Flows

Presents the sources of cash in your business—from net income, new capital, or loan proceeds—versus the expenditures, or uses of the cash, over a specified period of time. An example of the cash flow statement for F.E.D. Foods Company is shown below.

It's at this stage that you will appreciate having an effective accounting system. Without this system, you won't know if you are profitable or not, let alone if you are liquid enough (simply put, have enough cash on hand) to pay for the next order of merchandise. A good system also will help you track your company's growth and anticipate future cash needs.

F.E.D. Foods Co. Cash Flow Statement

($ Thousands)	Sources/(Uses)	
Operating Activities		
Net Income	$ 110	
Plus: Depreciation	50	
Decrease in Prepaid Expenses	1	
Increase in Deferred Tax Liability	10	
	171	
Less: Profit on Sale of Equipment (line 9(1992) + Note 1 - [- 9(1993) - Note 2)	(25)	represents changes not levels
Increase in Inventories	(7)	
Increase in Accounts Receivable	(8)	
Decrease in Accounts Payable	(4)	
Net Cash Provided From Operating Activities	**127**	
Investing Activities		
Capital Expenditures	(167)	
Increase in Investments	(50)	
Proceeds From Sale of Equipment	92	actual cash
Net Cash Provided From Investing Activities	**(125)**	
Net Cash Before Financing	2	
Financing Activities		
Proceeds From Sale of Stock	40	
Proceeds From Notes	13	
Dividends (Line m (1993)- change in line 20 (1993-1992))	(58)	
Net Cash Provided From Financing Activities	**(5)**	
Increase in Cash and Marketable Securities	**(3)**	

Notes: 1. Capital Expenditures in 1993 were $167,000.
2. Equipment sold in 1993 for $92,000.

· see how company performs year to year (trend analysis)
· compare to similar companies
· compare to industry avg (RMA)

Ratio Analysis

Another tool the lender will use is financial ratio analysis. Ratios permit review of a company's current financial performance versus that of previous years. In the same way that a medical checkup tests one's heart, lungs, and changeable factors such as body weight, an analysis of a company's financial performance considers the status, changes, and relationships of critical components of a company's health.

The lender also may use financial ratio analysis to consider how a company is doing when compared to another company. A limitation of such comparative analysis is that different industries are driven by different factors. As a result, the financial ratios of a manufacturer and retailer can be quite different even though both companies may be similarly successful.

Lenders are trained to appreciate both the benefits and limitations of ratio analysis and to consider financial results in the context of the company's "peer group" of similar companies within its industry. To find out what the benchmarks are for your type of business, you may refer to guides published by Robert Morris Associates and others.

The following section presents some widely used ratios from four financial ratio categories: profitability, liquidity, leverage, and turnover. The section also provides examples of the ratios calculated for the sample company, F.E.D. Foods Company. Your lender's analysis also may include ratios specific to your particular industry. For additional information on financial analysis and calculation of ratios, check with an accountant, your lender, or one of the sources listed in the Information Guide in this booklet.

Ratio Analysis

ofitability

Profit is the compensation an entrepreneur receives for the assumption o: risk in a business venture. The profitable business must cover its overhea expenses and generate profits for its owner out of its "after-product-costs cash.

Gross Profit Margin

One commonly used measure of profitability is gross profit, which is your sales minus your product costs. In ratio form, it is called the gross profit margin:

$$\text{Gross Profit Margin} = \frac{\overset{\text{Revenues}}{\text{Net Sales}} - \text{Cost of Goods Sold}}{\text{Net Sales}}$$

The gross profit margin for F.E.D. Foods Company for 1993 is:

$$\frac{\$633{,}000-\$358{,}000}{\$633{,}000} \times 100 = 43.4\ \%$$

(from profit and loss statement, page 12, (lines a-b)/line a)

Operating Profit Margin

Another measure of your profitability is the operating profit margin. This is the core cash flow source that is expected to grow year to year as your business grows, and it excludes interest expense, taxes, and "extraordinary items" such as the sale of property or other assets.

Higher profitability from one year to the next is generally considered a good sign for a company.

try to separate fixed costs & variable costs

$$\text{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{Net Sales}}$$

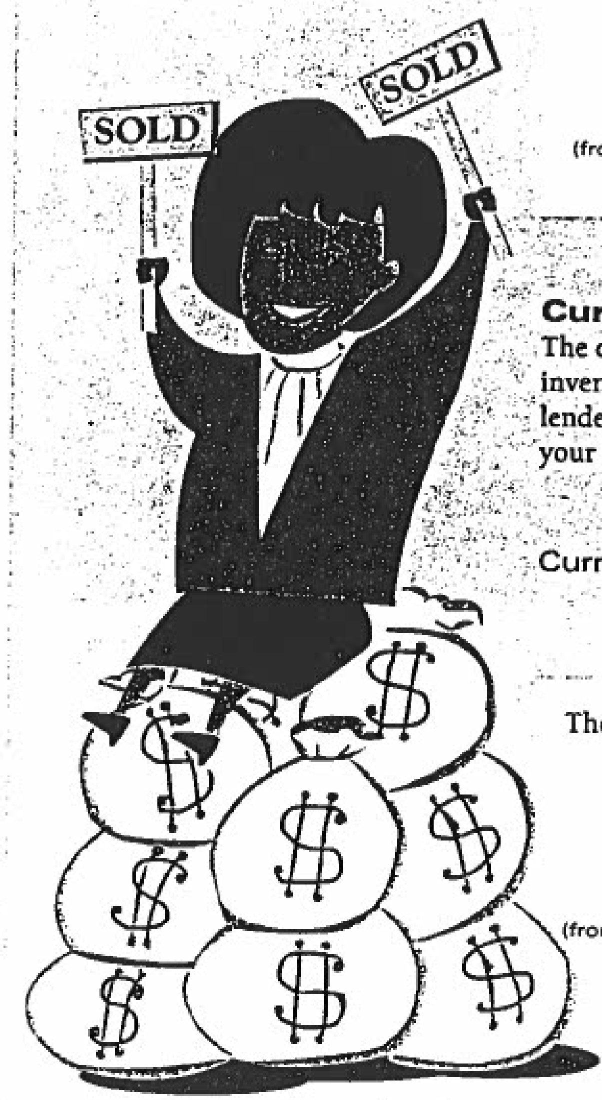
The operating profit margin for F.E.D. Foods Company for 1993 is:

$$\frac{\$164{,}000}{\$633{,}000} \times 100 = 25.9\%$$

(from profit and loss statement, page 12, line h/ line a)

difference between operating profit and
cash flow EBIT + Depreciation / Amortization

Liquidity



How much cash does your business have on hand for immediate use?

Quick Ratio

The quick ratio shows what assets your business can immediately convert to cash, such as the business checking account and money market accounts.

$$\text{Quick Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Accounts Receivable}}{\text{Current Liabilities}}$$

The quick ratio for F.E.D. Foods Company for 1993 is:

$$\frac{\$3{,}000 + \$8{,}000 + \$42{,}000}{\$118{,}000} = 0.45$$

(from balance sheet, page 11, line 1 + line 2 + line 3/line 15)

Current Ratio

The current ratio is a broader indication of liquidity because it includes inventory. For purposes of showing your immediate access to cash, many lenders find it less useful than the quick ratio. In general, lenders look for your current assets to exceed your current liabilities.

ask class identify types of current assets

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

ask what constitutes current liabilities

The current ratio for F.E.D. Foods Company for 1993 is:

$$\frac{\$212{,}000}{\$118{,}000} = 1.8$$

(from balance sheet, page 11, line 6/line 15)

Leverage

The leverage ratios measure the company's use of borrowed funds in relation to the amount of funds provided by the shareholders or owners. These ratios tell the lender how much money you have borrowed versus what money you and other owners have put into your company. This is important because borrowed money carries interest costs and your business must generate sufficient cash flow to cover the interest and principal amounts due to the lender. Generally speaking, companies with higher debt levels will have higher interest costs to cover each month, so low to moderate leverage is nearly always viewed more favorably by prospective lenders.

Debt Ratio

The most common leverage ratio is called, simply, the debt ratio:

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Liabilities + Capital}}$$

The debt ratio for F.E.D. Foods Company for 1993 is:

$$\frac{\$195{,}000}{\$1{,}112{,}000} \times 100 = 17.5\ \%$$

(from balance sheet, page 11, line 18/line 21)

Debt/Equity

Components of equity
- owners contribution
- retained earnings

Turnover

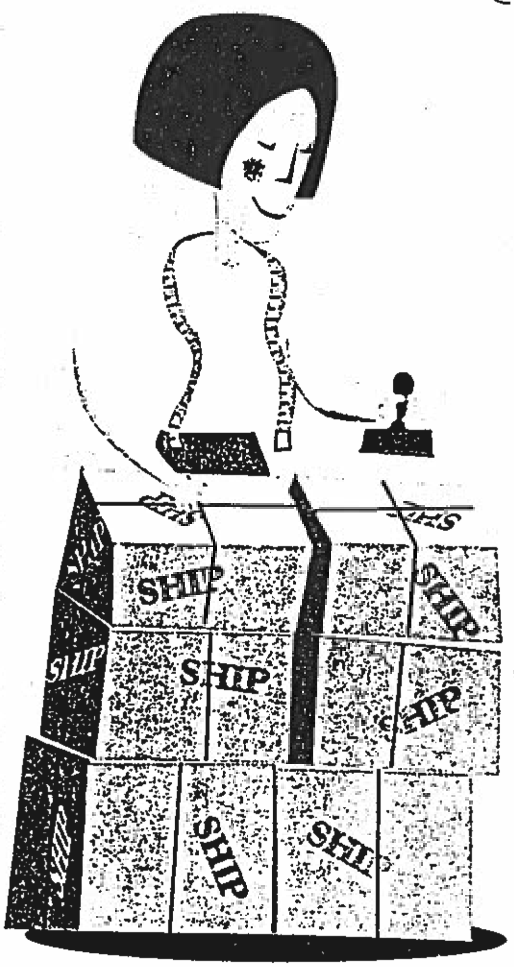
[illegible] - working capital line

The turnover ratios focus on the operating cycle of your business by examining its cash flow. They show the amount of time it takes for cash to move through the accounts receivable, inventory account, and accounts payable in your business.

It is important to know how many days it takes your company to purchase inventory, pay for it, sell it, and collect the cash for the sales. Those sales you make on the customer's promise to pay at a later date (also known as credit sales) may not actually produce cash for 30 to 60 days. You can get squeezed if you don't understand this cycle and find that you have to pay for new supplies before your customers have paid you. need for bank line or cash reserves

Gaining an understanding of the cash flow of your business is the most important financial planning tool you have. An examination of the turnover ratios can help you to understand the operating cycle in your business.

The three turnover ratios are the collection period ratio, the days to sell inventory ratio, and the days purchases in accounts payable ratio.



Collection Period Ratio

First, the collection period ratio indicates how quickly you collect the cash your customers owe you. The earlier you collect it, the sooner you can put it to work purchasing more inventory or paying for current orders; so the lower the number, the better.

$$\text{Collection Period Ratio} = \frac{\text{Average Accounts Receivable}}{\text{Net Sales}} \times 365$$

The collection period ratio for F.E.D. Foods Company for 1993 is:

$$\frac{(\$42{,}000 + \$33{,}000)/2}{\$633{,}000} \times 365 = 22 \text{ days}$$

(from balance sheet, page 11, and profit and loss statement, page 12, ((line 3 (1993) + line 3 (1992)/two)/line a) X 365)

start thinking about a collection process

Days to Sell Inventory Ratio

Along the same lines is the second turnover ratio, the days to sell inventory ratio. The days to sell inventory ratio tells how efficient you are at matching your purchases to your sales. Low inventory days indicate that you've accurately forecasted the demand for your product. That way excess inventory isn't accumulating on your shelves and adding to costs.

$$\text{Days to Sell Inventory Ratio} = \frac{\text{Average Inventory}}{\text{Cost of Goods Sold}} \times 365$$

The days to sell inventory ratio for F.E.D. Foods Company for 1993 is:

$$\frac{(\$157{,}000 + \$150{,}000)/2}{\$358{,}000} \times 365 = 156 \text{ days}$$

how many turns? ~ 2.3x

(from balance sheet, page 11, and profit and loss statement, page 12, ((line 4 (1993) + line 4 (1992)/two)/line b) X 365)

Days Purchases in Accounts Payable Ratio

The days purchases in accounts payable ratio is the third turnover ratio. This ratio measures how quickly you pay your suppliers for inventory purchased. Generally speaking, it is advantageous for small businesses to pay for products promptly so they can take advantage of price discounts.

weigh this against need for cash

$$\text{Days Purchases in Accounts Payable Ratio} = \frac{\text{Average Accounts Payable}}{\text{Cost of Goods Sold} + \text{Change in Inventory}} \times 365$$

The days purchases in accounts payable ratio for F.E.D. Foods Company for 1993 is:

$$\frac{(\$38{,}000 + \$42{,}000)/2}{\$358{,}000 + \$7{,}000} \times 365 = 40 \text{ days}$$

(from balance sheet, page 11 and profit and loss statement, page 12, ((line 13 (1993) + line 13 (1992)/two)/(line b + change in lines 4)) X 365)

Pro Forma Financial Statements and Financial Projections

Pro forma financial statements are the entrepreneur's best guess about what next year will look like for the business. These tools will help you anticipate whether next year's cash flow will be sufficient to cover all your costs, and if not, how much money you will need to borrow.

For a longer horizon, financial projections permit you to make estimates about future sales levels, expansion costs, or general business conditions and see how such conditions would affect your company's financial results in the years to come.

The preparation of pro formas and projections is a complex exercise that requires a sound knowledge of financial accounting. A comprehensive discussion of these tools is beyond the scope of this text. However, with the help of your accountant or the advice of one of the sources listed in the Information Guide, the exercise can provide both you and your potential lenders with valuable insights into your business.

These are pro forma financial statements for F.E.D. Foods Company, which expects its sales to increase by 25 percent for 1994. The pro forma statements show how an expected sales increase will change the company's profit and loss statement and balance sheet forecast for next year.

F.E.D. Foods Co. Pro Forma Balance Sheet

As of December 31,	1994 ($ Thousands)
Assets	
Current Assets	
1. Cash	$ 4
2. Marketable Securities	10
3. Accounts Receivable	52
4. Inventories	196
5. Prepaid Expenses	2
6. Total Current Assets	264
7. Plant, Property, and Equipment	1,242
8. Less Accumulated Depreciation	508
9. Net PPE	734
10. Investments	333
11. Other Assets	21
12. Total Assets	1,352
Liabilities	
Current Liabilities	
13. Accounts Payable	48
14. Notes Payable	100
15. Total Current Liabilities	148
16. Long-Term Debt	0
17. Deferred Tax Liability	96
18. Total Liabilities	244
Capital	
19. Common Stock	367
20. Retained Earnings	639
21. New Cash Needs or (excess Cash)	102
22. Total Liabilities and Capital	1,352

Notes: 1. Capital Expenditures are estimated to be $175,000 for 1994.

F.E.D. Foods Co. Pro Forma Profit and Loss Statement

Year Ended December 31,	1994 ($ Thousands)
a. Net Sales	$ 792
b. Cost of Goods Sold	448
c. Gross Profit	344
d. Selling and Administrative Expenses	27
e. Lease Payments	17
f. Depreciation	58
g. Repairs and Maintenance	21
h. Operating Profit	221
Other Income (Expense)	
i. Interest Income	2
j. Interest Expense	0
k. Earnings Before Income Taxes	223
l. Income Taxes	76
m. Net Earnings	147

Notes: 1. Capital Expenditures in 1992 were $1,000.
2. Equipment sold in 1992 for $550.

also do cash flow stmt to identify which company's [illegible] during [illegible]

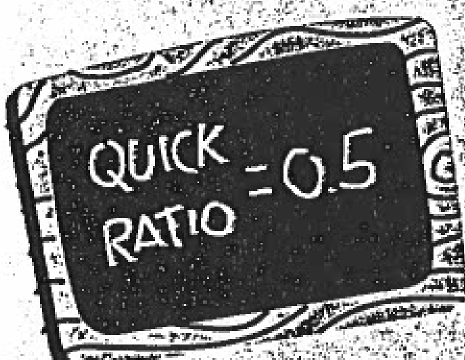
Resources and How to Use Them

There are numerous programs available to assist prospective and existing small business owners. Many are wholly or partially funded by federal or local government entities and can provide services to you at low or no cost. Sometimes staffed by university professors and graduate business students, retired business executives, or small business consulting specialists, these programs are excellent sources of advice. An abbreviated list of resources in your area appears in the Information Guide located in the back pocket of this booklet.

Types of Assistance

Small business assistance programs generally fall into two categories: training programs, which teach business owners technical and financial skills, and loan programs, which offer loans or loan guarantees for small businesses.

Training Programs



Depending on the organization and on your particular needs, training programs offer skill-building assistance either in the classroom for several weeks or in individual counseling sessions.

Technical assistance programs can cover a wide range of topics and their applicability depends on the nature of your business. Topics may include production, marketing, distribution, packaging, import/export documentation, and human resources or staff management.

Financial skills assistance programs may include basic accounting, cash flow management, sales projections, feasibility studies, and tax planning.

Business plan development courses include components of both the technical and financial programs and assist you with composing, preparing, and presenting your business plan and loan proposal to prospective lenders.

Loan Programs

Loan programs are among the resources offered by small business investment corporations and state or local development corporations. These programs typically have funds available to lend directly to new or expanding businesses. They also may offer guarantees or other support for a loan given by a traditional lender, such as a bank, to help mitigate the bank's risk of lending directly to a new small business.

Loan Programs
(continued)

One advantage of approaching an organization with a loan program rather than a bank is that the organization may have funds dedicated solely to the new small business market. It also may be receiving some type of government subsidy that permits it to offer lower interest rates for small business loans. Programs that provide guarantees from a government agency to pay the loan if your business fails may convince a bank to lend to your business when it otherwise wouldn't.

Small Business Administration

Created in 1953, the Small Business Administration (SBA) provides management and financial assistance to small businesses. Mainly, the SBA guarantees loans through financial institutions. The loans may be used for working capital, machinery and equipment, acquisition of real estate, and expansion.

· Low Doc
· 7a program

If Your Application Is Not Approved

If your loan is not approved, ask why. You are entitled by law to a written statement of the reasons for a loan denial, if you request it. Many banks automatically supply the reasons for denial in writing.

Knowing the reasons for a loan denial can inform you of areas in your proposal that didn't meet the lender's standards. Since all lenders do not share identical standards, another lender may reach a different credit decision. Review your loan proposal in light of the lender's comments. See how you can use the resources or ideas presented in this booklet to strengthen your application. Go through the process of reviewing your technical and financial material again, and then review your business plan. Find any areas that could be augmented further and lead to an approval on your next request.

If you believe you have been denied credit unlawfully, you should contact the regulatory authority that supervises the institution. A list of the regulatory agencies in your area is located in the Information Guide. The Equal Credit Opportunity Act (Federal Reserve Regulation B) prohibits lenders from denying your application on the basis of race, color, religion, national origin, sex, marital status, or age, or from discouraging you from applying, or giving you less favorable terms than any other applicant, on such a basis.

Glossary

Accounts payable: Amount owing to creditors for goods and services on an open account.

Accounts receivable: Amount due from customers for merchandise or services purchased on an open account.

Asset: Anything owned by a business or individual that has commercial or exchange value.

Balance sheet: Financial statement that presents a "snapshot" of what the business owns, what it owes, and what equity it has on a given date.

Capital: See Equity.

Capital expenditures: Purchases of long-term assets, such as equipment, used in manufacturing a product.

Cash flow: Incoming cash to the business less the outgoing cash during a given period. Also used to refer to the figure derived from net income plus noncash items charged off in the accrual accounting process.

Collateral: Assets pledged to secure a loan.

Collection period ratio: Indicates how quickly your customers pay you. Average accounts receivable divided by net sales, multiplied by 365.

Community Reinvestment Act (CRA): Under provisions of the Community Reinvestment Act of 1977, banks and thrift institutions seek opportunities to help meet the credit needs of their local communities, including low- and moderate-income neighborhoods, consistent with safe and sound operation of the institutions.

Compensating balance: Money a bank requires a company to leave in a deposit account as part of a loan agreement.

Corporation: Form of business ownership that is a legal entity on its own and puts stockholders and the board of directors in control. Owners have limited liability for the corporation's actions. A corporation has unlimited life and in most cases is taxed as an entity on its own.

Cost of goods sold: Figure representing the cost of buying raw materials and producing finished goods.

Current assets: Cash or other assets you expect to use in the operation of the firm within one year.

Current liabilities: Debts you expect to pay within one year.

Current ratio: Shows the firm's ability to pay its current obligations from current assets. Current assets divided by current liabilities.

Days purchases in accounts payable ratio: Indicates how quickly you pay your suppliers for inventory purchases. Average accounts payable divided by the cost of goods sold plus change in inventory, multiplied by 365.

Days to sell inventory ratio: Indicates the firm's efficiency at matching purchases to expected sales. Average inventory divided by the cost of goods sold, multiplied by 365.

Debt ratio: Indicates the firm's debt level, or leverage. Total liabilities divided by total liabilities plus capital.

Depreciation: Amortization of the cost of a fixed asset, such as plant and equipment, over several years, or the "depreciable life."

Dividend: Distribution of earnings to shareholders.

Equal Credit Opportunity Act (Federal Reserve Regulation B): Prohibits lenders from denying your application on the basis of race, color, religion, national origin, sex, marital status, or age, or from discouraging you from applying, or giving you less favorable terms than any other applicant, on such a basis. Regulation B also contains specific rules governing credit transactions.

Equity: The ownership interest in a business remaining after its liabilities are deducted. Also known as common stock plus retained earnings, or capital.

Extraordinary items: Unusual or nonrecurring event that must be explained to shareholders or investors, such as a manufacturer's sale of a building.

Finance company: Competitors of commercial banks in providing credit to households and firms. Unlike banks, they do not accept deposits.

Financial projections: Estimates of the future financial performance of a firm.

Financial statements: Written record of the financial status of an individual or organization. Commonly include profit and loss, or income, statement; the balance sheet, which includes a statement of the company's retained earnings; and the cash flow statement.

Fixed assets: Long-term assets such as buildings, equipment, or property that are not expected to be converted to cash in the near term.

Gross profit: Indicates the revenues of the firm before consideration of its operating expenses. Net sales less cost of goods sold.

Gross profit margin: Measures a firm's profitability. Gross profits divided by net sales.

Gross income: Net sales less cost of goods sold.

Installment loan: Loan type that is paid in periodic payments, such as an automobile loan.

Inventory: Value of a firm's raw materials, work in process, supplies used in operations, and finished goods.

Investor: An individual who takes an ownership position in a company, thus assuming risk of loss in exchange for anticipated returns.

Leverage: Measures the firm's use of borrowed funds versus those funds provided by the shareholders or owners (equity).

Line of credit: Although not a contract, a bank's promise to lend to a specific borrower up to a pre-agreed amount during a specific time frame. Usually reviewed annually and subject to cancellation without notice.

Liquid assets: Those assets that can be readily turned into cash.

Liquidity: Gauges firm's ability to quickly turn assets into cash.

Marketable securities: Securities that are easily sold.

Net income: The sum remaining after all expenses have been met or deducted. Also called profit.

Net sales: Gross sales minus returns and allowances.

Net worth: Excess of assets over debt.

Niche: Particular speciality in which a firm has gained a large market share

Operating expenses: Those costs associated with the day-to-day activities of the business.

Operating profit (loss): Income or loss before taxes and extraordinary items resulting from transactions other than those in the normal course of business.

Operating profit margin: Measures a firm's profitability by examining the pre-tax profit generated from primary operations (versus extraordinary items) in relation to net sales. Operating profit divided by net sales.

Partnership: Can be general or limited, but in either case the general partners are in control. The tax burden is shared by all the partners at their personal rate, and the general partners have unlimited liability. Limited partners have limited liability.

Principal: The currently unpaid balance of a loan, not including interest owed. Also can refer to a primary owner or investor.

Profit: Compensation an entrepreneur receives for the assumption of risk in a business venture. Also called net income.

Profit and loss statement: Summary of the revenues, costs, and expenses for a business over a period of time. Also called the income statement.

Pro forma financial statements: Financial statements for a business where certain amounts shown are hypothetical, or estimated, for the period depicted.

Quick ratio: Liquidity ratio that focuses on the firm's most liquid assets by excluding inventory. Also known as the acid test ratio. Cash, marketable securities, and accounts receivable divided by current liabilities.

Retained earnings: Net profits kept to accumulate in a business after dividends are paid.

Seasonal loan: A loan made for the purpose of meeting predictable and periodic funding needs, such as funding of camping gear inventory before summer purchases.

Small Business Administration (SBA): Federal agency created in 1953 to provide management and financial assistance to small businesses. Mainly, the SBA guarantees loans through financial institutions. The loans may be used for working capital, machinery and equipment acquisition of real estate, and expansion.

Sole proprietorship: A type of business where the owner has full control and unlimited liability. A sole proprietorship is taxed at the personal income tax rate.

The Credit Process: A Guide for Small Business Owners offers guidance to small business owners who are seeking outside financing for the first time.

While a comprehensive discussion of accounting, finance, and marketing fundamentals is beyond the scope of this booklet, we have presented an overview of these concepts as applied to a small business. The sources and types of funding typically available to small businesses are covered along with a discussion on creating a business plan.

For more information and assistance, consult the list of resources included in the Information Guide in the back pocket of this booklet. For additional copies of this booklet, contact your local Federal Reserve Bank.

Text: Tracy L. Penwell
Design & Production: Publication Productions
Illustrations: Tuko Fujisaki

Acknowledgments

Special thanks to Gail Donovan, Susan Hammel Joyce, and Stephanie Stephens of the Federal Reserve Bank of New York for their assistance in writing, editing, and producing this booklet.

The assistance of other individuals inside the Federal Reserve Bank of New York and outside the Bank also is greatly appreciated.

This Community Affairs Office booklet is distributed by the Public Information Department.

The Federal Reserve Bank of New York
Public Information Department
33 Liberty Street
New York, NY 10045
(212) 720-6134