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THE POLICIES AND PRACTICES OF MONTANA BANKS REGARDING  
TERM LENDING, AND FINANCIAL STATEMENT ANALYSIS  
FOR BUSINESS LOANS

By

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B.A., Carroll College, 1968

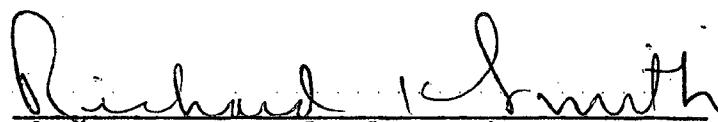
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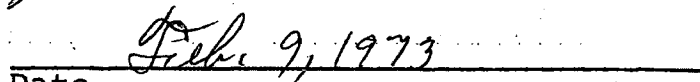
UNIVERSITY OF MONTANA

1972

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## CHAPTER I

### INTRODUCTION

The primary objectives of this thesis are to determine the policies and practices of Montana banks in making commercial and industrial loans, and their requirements for financial statements for all types of business loans.

This study is intended as source and information for the businessman, business student and the young banker regarding the nature and requirements of business lending in Montana. The experienced banker should find the policy differences among individual banks interesting.

Chapter II is a general discussion of term lending policies and practices followed on a national scale. Topics discussed include types of term loans, security, interest rates, maturities, prepayments, and term loan agreements. This information was gathered from a number of books and articles on the subject.

Chapter III explores the role of the Small Business Administration (SBA) in term lending. Eligibility standards, regulations and policies governing SBA participation and guarantees are explained. SBA term lending activities in Montana are also discussed. Research for this section

included the study of SBA publications, policies and definitions, as well as a personal interview with the Montana SBA Field Officer.

To learn more about commercial bank lending to business firms in Montana, a two-part questionnaire (Appendix A) was prepared. The results of this questionnaire are discussed and compared to the policies and practices of banks in general in Chapters IV and V. Chapter IV reviews the answers to 37 questions about the policies and practices of Montana banks in making business term loans. Some questions about short-term loans were also asked to reveal policy differences between them and term loans. Chapter V discusses answers to the second portion of the questionnaire, which consisted of 13 questions regarding the financial statements and information required on all types of business loans.

The survey questionnaire was sent to 26 banks throughout the state. A questionnaire was sent to every bank with deposits of over \$20 million. Smaller banks were not surveyed because it is believed that they do not make a significant amount of term loans. Completed questionnaires were promptly returned by 19 cooperating banks. To supplement the questionnaire, personal interviews were conducted with a number of prominent bankers and loan officers.

## CHAPTER II

## A GENERAL DISCUSSION OF TERM LENDING

A bank term loan is a business loan with a maturity in excess of one year but usually less than ten years and normally repayable in quarterly, semi-annual or annual installments. Term loans help to fill the requirements of businesses for intermediate term financing that is needed for making additions to plants and equipment, increasing the supply of working capital, and numerous other purposes.

During the depression of the 1930's, banks and business borrowers were both hurt when short term loans arranged to cover long term purposes could not be renewed, forcing liquidation of assets. Term loans have developed to supply the borrower with the funds he needs for his business until he is financially able to repay the loan. Well conceived term loan agreements tied to realistic and conservative cash flow forecasts can avoid forced liquidations in hard times. Usually the repayment schedule is geared to the cash flow generations of the borrower over the duration of the loan.<sup>1</sup>

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<sup>1</sup>Benjamin H. Beckhart, Business Loans of American Commercial Banks (New York: The Ronald Press Company, 1959), p. 208.



The principal limiting factor in the ability of banks to finance term loans is liquidity. Each bank must see that the amount, quality, and maturity schedules of its term loan portfolio are in harmony with its seasonal deposit and loan fluctuations, type of deposits, capital accounts and required reserves. It is also important that a bank not become so overloaded in intermediate term loans that it is unable to satisfy the short-term or seasonal needs of its customers.

#### Types of Term Loans

In practice there are three types of term loans. The first is the ordinary term loan which matures in one to ten years, and is supported by a written agreement outlining the provisions of the loan and obligations of the borrower. The second type of term loan is the revolving credit loan, which represents a legal commitment on the part of the bank to extend a line of credit to the borrower over the life of the agreement. The agreement usually lasts for two to three years and borrowings are made through a series of short term, 90 day notes that by agreement are renewable. Because these short term notes are renewable and in essence represent a continuous commitment of loan funds to borrowers for periods in excess of one year, they are classified as term loans. Revolving credit agreements

sometimes have a conversion privilege that allows the borrower, at his option, to convert it into a regular term loan. This provides flexibility in that the borrower has the credit available to meet the uncertain and fluctuating needs of new projects and a guarantee of longer term financing when financial requirements are better known.<sup>2</sup>

The third type of term loan is the continuously renewed short term loan. This loan, while not technically a term loan because of its maturity, is in effect a term loan because it is in most instances routinely renewed, in whole or in part, at maturity. There is no formal agreement guaranteeing renewal of the loan, but so long as the borrower's credit worthiness has not changed significantly, the loan is more or less automatically renewed.<sup>3</sup> Security is required in proportionately more term loans than short term loans and from more small borrowers than large borrowers because of the greater risk involved.<sup>4</sup>

### Security

Plant and equipment are the primary types of security

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<sup>2</sup>James C. Van Horne, Financial Management and Policy (Englewood-Cliffs, N.J.: Prentice-Hall, Inc., 1968), p. 445.

<sup>3</sup>Federal Reserve Bank of New York, Essays in Money and Credit (New York: Federal Reserve Bank of New York, 1964), p. 63.

<sup>4</sup>Edward W. Reed, Commercial Bank Management (New York and London: Harper and Row, 1963), p. 307.

for term loans, followed by stocks and bonds, accounts receivable, government guarantees and inventory.<sup>5</sup> It is thought that term loans secured by plant, equipment, or real estate are primarily used to purchase fixed assets and that loans secured by receivables and inventories are used to increase the working capital of businesses.<sup>6</sup> When they feel the protection is not necessary, banks do not require the pledging of security because of the effort and expense involved.

#### Interest Rates

Interest rates charged on term loans are usually somewhat higher than rates charged on comparable short term loans because of the uncertainty of business conditions over the long term and changes in the interest rates. Term loans to prime borrowers are commonly one-fourth to one-half of a percentage point higher than the prime rate. However, this does not hold true for the majority of term borrowers, which are small and moderate-sized corporations, and because of their size and the risk involved, do not qualify for the lowest rate. A large number of small businesses borrow a relatively small amount of the aggregate term money lent and pay rates substantially higher than the prime rate. However, a large part of the total term lending is to major corpora-

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<sup>5</sup>Beckhart, op. cit., p. 225.

<sup>6</sup>Reed, op. cit., p. 307.

tions, many of which are able to borrow on a term basis at rates only slightly above the prime bank rate.

The interest rate on a term loan may be either a fixed rate for the life of the loan, or a rate that changes at prescribed intervals during the loan, or a variable interest rate that is adjusted in tune with changes in the prime bank rate. Agreements which provide for a fluctuating rate may also provide for a floor and ceiling, of say, one percentage point above and below the initial rate. The purpose of a fluctuating rate from the bank's standpoint is to protect the earnings of the bank by tying the interest rate to the wholesale cost of money, thereby insuring the bank's margin of profit. Revolving credit loans may have one interest rate during the revolving credit period and another rate when it is converted to an ordinary term loan.<sup>7</sup>

A commitment fee is commonly charged if the money is not "taken up" at the time the term loan agreement is executed. This fee is the bank's charge for reserving the loan amount at an agreed upon interest rate until such time as the borrower decides to take out the money and pay interest. The amount of the fee depends on the length of the commitment, but one-half of one percent per annum on the amount committed and not borrowed is standard for a one

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<sup>7</sup>Van Horne, op. cit., pp. 443-444; and, Beckhart, op. cit., pp. 220-222, 226.

year commitment.<sup>8</sup>

Banks sometimes use compensating balances to increase the effective interest rate on term loans, to moderate fluctuations in deposit balances, and to provide partial insurance against possible losses. A compensating balance provision requires a borrower to maintain with the bank a minimum average deposit balance of between 10 per cent and 20 per cent of the amount of the term loan. The cost of the loan increases to the extent that the compensating balance requires the borrower to maintain deposit balances higher than normal and pay interest on this money that is not being used.

Most banks require compensating balances on large term loans, and more large banks require compensating balances than do small ones. Often a bank will not formally demand that a borrower maintain a compensating balance if in practice he voluntarily holds deposit balances that are equal to or greater than the compensating balance the bank normally requires. Customers that fail to maintain proper deposit balances can expect bank action in the form of persuasion, higher interest rates, reduction of credit lines or cancellation of the loan.

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<sup>8</sup>Beckhart, op. cit., p. 227.

<sup>9</sup>Federal Reserve Bank of New York, op. cit., pp. 57-58.

During times of tight money and high interest rates, banks require high compensating balances from most large borrowers. In easier money times when interest rates are low and competition for borrowers is tough, banks reduce the percentage of a loan required as a compensating balance. A compensating balance must be considered by the borrower as part of the cost of taking out a term loan. In addition to interest costs, the cost of compensating balances, and commitment fees, the borrower is expected to pay for all legal costs incurred by the bank in drawing up the term loan agreement.<sup>10</sup>

#### Maturities

While term loans ordinarily mature in one to ten years, most term loans are made with final maturities of between two and six years, with payments usually required on a quarterly, semi-annual or annual basis. Although term loans with duration in excess of ten years account for a very small fraction of all term loans, the trend has been for an increase in the average maturity length of term loans.<sup>11</sup> If the borrower's expansion involves heavy start-

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<sup>10</sup>Ibid., p. 61; also, Van Horne, op. cit., pp. 419-420.

<sup>11</sup>"Member Bank Term Lending to Business, 1955-1957," Federal Reserve Bulletin (April 1959), p. 353.

up costs, a bank will at times reduce or defer payments during the early part of the loan. Also, a final balloon payment is sometimes used when the borrower's projected cash flow is not adequate to amortize the loan in equal installments. Loan provisions sometimes require at least partial retirement of the balloon payment if assets are sold or if net income and cash flow is higher than expected. Banks are inclined to use a balloon payment when they do not want to commit themselves to a term loan of such long length as to allow repayment in small equal installments. Customarily, the balloon payment is refinanced by the bank at maturity. This refinancing gives the bank the opportunity to take fresh look at the credit situation, and if appropriate, renegotiate the loan in light of the current conditions of the business and the economy.<sup>12</sup>

#### Prepayments

Most bankers are happy to receive term loan prepayments with money generated from cash flow or external sources except when the source of funds for the prepayment is a competing bank charging a lower rate of interest. Prepayments originating from noncompetitive sources are accep-

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<sup>12</sup>Douglas A. Hayes, Bank Lending Policies: Issues and Practices (Ann Arbor, Michigan: University of Michigan, 1964), Michigan Business Studies, XVIII, No. 4, pp. 103-104; also, Beckhart, op. cit., p. 227; Reed, op. cit., pp. 307-308.

table to banks because term loans that are prepaid become, in effect, shorter in length and, therefore, more liquid and less risky and, at the same time, earn interest at a higher rate during the loan's duration than that charged for short term loans.<sup>13</sup>

#### Term Loan Agreements

The bank and the borrower enter into a term loan agreement outlining the provisions of the loan and the obligations of both the bank and the borrower. The agreement can be either a part of the actual term loan note or a separate document identified in the note. Term loan agreements are tailored to the borrower's individual circumstances. General terms in the agreement include the amount of the loan, maturity, repayment schedule, interest rates, fees, prepayment, security, and use of the loan proceeds.<sup>14</sup>

Term loan agreements have affirmative covenants that impose restrictions on the borrower's management by stating specific things that must be done. One important covenant requires the borrower to submit balance sheets, profit and loss statements and other pertinent financial information on a regular basis. Quarterly reports usually must be certified by an officer of the borrowing business,

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<sup>13</sup>Beckhart, op. cit., p. 228.

<sup>14</sup>Reed, op. cit., p. 318.



and annual statements must be audited and certified by a public accountant. Another covenant requires that adequate insurance be carried on the assets of the borrower. Also, in loans to small firms, "key-man" insurance that provides a cushion if an important manager is lost usually must be carried on managers who are essential and vital to the business' success.<sup>15</sup> Furthermore, banks usually reserve final approval on the hiring of new "key" personnel.

The maintenance of minimum working capital is an important covenant. Its purpose is to insure that the borrower has sufficient working capital to pay current obligations and operate efficiently. Sometimes this covenant is set up with two working capital minimums. If the higher minimum is violated, the borrower is prohibited from paying dividends or making capital expenditures until the proper level of working capital is restored, and if the lower minimum is breached, the bank has a right to default the entire loan. Net worth also usually must be maintained at a specified level. This insures that the equity capital position will not be decreased and weakened while the loan is in effect.

Negative covenants of term loan agreements prohibit

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<sup>15</sup>Ibid., pp. 319-320; also, Hayes, op. cit., p. 112.

<sup>16</sup>Reed, op. cit., p. 320; also, Beckhart, op. cit., pp. 228-229; Hayes, op. cit., pp. 112-113.

actions by the borrower that the bank does not want to occur without its prior approval. Their purpose is to safeguard the assets and financial strength of the borrower while the loan is in effect. A "negative pledge clause" is usually incorporated in the agreement when the term loan is unsecured and sometimes even when the loan is secured. This clause prohibits the borrower from selling securities or pledging assets or inventory as security to other lenders. Since the primary purpose of the clause is to assure that subsequent lenders do not obtain more favorable security than the original lender, banks sometimes allow assets to be pledged if they already have adequate security. Negative covenants also prohibit the sale of substantial ownership or assets of the business, mergers, and the issuance of guarantees without the bank's approval. If conditions warrant, banks usually will allow a merger if both businesses agree that all provisions of the original loan agreement apply to the newly formed business.<sup>17</sup> Restrictive clauses impose limitations on the discretionary decisions of business borrowers to insure safe financial actions. Limitations are placed on additional long and short term borrowing, but banks normally allow seasonal short term loans or trade credit and further term borrowing up to

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<sup>17</sup>Reed, op. cit., pp. 320-321; also, Beckhart, op. cit., p. 229.

specified levels. Permissible levels of added term borrowing are often determined by asset ratios with long term leases considered as debt. Restrictive clauses can also cover the future capital expenditures, investments, and obligations of the borrower. The acquisition of other companies or stock is limited to the bank's estimation of the borrower's financial condition. Often the purchase of stock is prohibited to prevent speculation. The borrower's investment in new plant, equipment and other fixed assets usually is controlled and is sometimes limited to the borrower's annual depreciation expense. Restrictions on the payment of dividends, retirement of capital stock and/or retirement of other long term debt are closely tied to the covenants regarding the maintenance of sufficient working capital and net worth. Inappropriate financial action in these areas can diminish working capital and net worth. In any one year, unless a portion of the bank's term loan is repaid, the amount that can be paid to other long term lenders may be limited. This is to insure that the other lenders are not the only ones repaid with earnings generated by the bank's loan. Also prevented is the repayment of other debts with funds provided by the bank. The final category of restrictive clauses, sometimes found in loans to smaller borrowers, covers salaries, bonuses, and advances to employees of the borrower. Banks like to have the final

approval on payments to high priced personnel when they feel there is a chance that excessive payments will weaken the borrower financially.<sup>18</sup>

All bank term loans contain default provisions. One important default provision normally found in a term loan agreement covers the failure of the borrower to pay principal or interest as agreed. Another common default provision concerns the misrepresentation of facts in the borrower's financial statements. False financial information is considered to be an indication of not only financial instability but also of poor moral character. Insolvency or bankruptcy may also automatically make the loan due and payable. A general default provision concerns the breach or failure to comply with any negative or affirmative covenant or restrictive clause of the loan agreement. Most agreements also contain a provision specifying that the term loan is in default if the borrower goes into default on any other debt.<sup>19</sup>

Grace periods are usually provided in the case of involuntary or unintentional defaults, to give the borrower time to correct violations.<sup>20</sup> Intentional defaults are normally not given a grace period.

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<sup>18</sup>Ibid., pp. 321-322; Ibid., pp. 228-229.

<sup>19</sup>Reed, op. cit., pp. 322-323.

<sup>20</sup>Beckhart, op. cit., p. 230.

If any default provision is violated by the borrower, the loan becomes due and payable immediately through an acceleration of payments clause. The acceleration clause prevents banks from having to wait for scheduled repayment before suing for each individual payment.

The purpose of the default provisions and the acceleration clause is to afford banks a course of immediate legal action if borrowers do not live up to their loan agreements or become poor financial risks. It is only in extreme cases, however, that banks use litigation to handle problem loans. Often a waiver of the violated covenant is given or a formal adjustment of the loan agreement is made following a discussion of the situation with the borrower. Banks are flexible on these issues and try to avoid throwing valued customers into receivership over financial difficulties with a term loan. They will usually adjust the terms of a loan by extending maturities and reducing payments to see a borrower through a period of financial difficulty. This in practice makes the protective covenants more in the nature of guide lines for financial planning than legal restrictions, even though some concessions are usually required on the part of the borrower.<sup>21</sup>

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<sup>21</sup>Ibid.; also, Reed, op. cit., pp. 322-323; Hayes, op. cit., pp. 114-115.

## CHAPTER III

## SBA PARTICIPATION AND GUARANTEES

The Small Business Administration is a government agency that plays an important role in bank term lending. The SBA assists small businesses that otherwise could not obtain reasonable long term financing from banks. A small business is defined as "one that is independently owned and operated, not dominant in its field and meets employment or sales standards as developed by the agency."<sup>22</sup> The standards referred to generally are as follows: Annual employment in a manufacturing concern and its affiliates must be somewhere between 250 or 1,500, depending on the nature of the industry. In wholesaling, the cutoff points are five to fifteen million dollars in sales, depending on the industry. In retailing or service industries, the cutoff points are one to five million dollars in sales or receipts, again depending on the industry.<sup>23</sup> To prevent the possibility of

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<sup>22</sup>Small Business Administration, SBA Business Loans, OPI-18, Office of Public Information (Washington, D.C.: U.S. Government Printing Office, 1970), p. 3.

<sup>23</sup>Ibid., p. 5.

government interference in public communication, loans are not made to newspapers, or radio or television stations. Gambling operators, speculators, and investment enterprises are all ineligible for SBA loans in order to insure that the loans are used for productive purposes that improve employment, physical output of goods and services, and the public's well-being and standard of living. Furthermore, the loan proceeds cannot be used to repay creditors who are inadequately secured and in a position of taking a loss or to finance monetary distributions to principals of the borrowing business.<sup>24</sup>

The agency is not in competition with banks and will not get involved if the borrower is eligible for reasonable term credit, on its own, from a bank. If this is not the case, the SBA can participate in, or guarantee part of a bank term loan. In a few instances when banks do not want to have anything to do with a borrower, the SBA will make a direct term loan of up to \$100,000 without involving a bank. The borrower must obtain the services of an attorney to administer the loan. In Montana direct loans are rare and the few loans of this type that are processed usually involve minority groups.<sup>25</sup>

In participation loans, both the SBA and the bank

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<sup>24</sup>Ibid., pp. 7-9.

<sup>25</sup>Ibid., p. 5; also, Reed, op. cit., p. 310.

put up their respective share of the funds immediately. Deferred participations that allow the SBA to hold off on putting up its share until a later date are no longer in use. The maximum size of the agency's share is \$150,000. The bank's share must equal at least 25 percent of the loan or a larger amount sufficient to cover any term notes held by the bank that will be refinanced by the participation. The bank and the SBA receive repayments equally and there is no penalty for prepayment. Balloon payments are allowed but it is up to the bank, by itself, to refinance the balloon at the maturity of the loan. The maximum interest rate charged by the SBA in 1970 was 5 1/2 percent.<sup>26</sup>

The actual fixed rate on a new loan is determined quarterly and adjusts to changes in the New York prime rate and market rates on U.S. treasury bills. The rate charged on new national disaster loans is set monthly and on other disaster loan programs the rate is set annually. Currently, participating banks are allowed to charge a maximum interest rate of 8.25 percent on their portion of SBA loans. Banks may use a variable interest rate that by agreement is adjusted either semiannually or annually. When they use a

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<sup>26</sup>Small Business Administration, SBA: What It Is . . . What It Does, OPI-6, Office of Public Information (Washington, D.C.: U.S. Government Printing Office, 1970), p. 4; also, Reed, op. cit., p. 311.



variable rate, banks must follow downward fluctuations as well as upward ones. SBA participation agreements expressly prohibit banks from making borrowers maintain compensating balances.<sup>27</sup>

Under the SBA's loan guaranty plan, up to 90 percent of a bank term loan can be guaranteed as long as the amount guaranteed is not more than \$350,000. Under this program the SBA does not put up any money unless the loan sours, and within certain limitations the bank sets the interest rate to be charged. SBA loan guarantees can expand the lending limit of the cooperating bank. For example, suppose that a customer of a bank wants a \$50,000 term loan and the bank has a legal lending limit of only \$25,000. If the SBA guarantees 90 percent or \$45,000 of the loan, then the bank's total exposure in the loan is only \$5,000 and it still has \$20,000.<sup>28</sup>

The SBA also guarantees revolving credit loans. In Montana these loan guarantees are usually made to contractors for use in financing a specific construction contract. The loan lasts until the project is completed, usually for at least a year, and the contractor is paid for his work. The contractor normally has a number of contracts lined up

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<sup>27</sup>Small Business Administration, Interview with the Loan Officer at the Montana SBA Field Office, July 1972.

<sup>28</sup>SBA, SBA: What It is . . ., op. cit., p. 4.

in advance, and when one contract is finished, a new line of credit is set up to finance the next project. At no time can the loan exceed \$350,000, and there is no conversion feature to make it a regular term loan.<sup>29</sup>

The SBA loan program also includes pool loans to corporations, Economic Opportunity loans to the disadvantaged, State and Local Development Company loans,<sup>30</sup> Minority Enterprise loans, Small Business Investment Company loans, lease guarantees, and disaster loans. The disaster loan category includes Physical Damage loans, Economic Injury loans, Product Disaster loans and Federally Displaced Business loans.<sup>31</sup> In addition, loans are granted under the Consumer Meat Protection Act, the Coal Mine Health and Safety Act, and the Occupational Health and Safety Act. It is foreseeable that in the future the SBA will become involved in loans to finance businesses in complying with the new environmental laws and requirements.<sup>32</sup>

SBA personnel have the ability to give management consultation. The agency is able to offer expert advice in the areas of accounting, marketing, research and development, product analysis and production.<sup>33</sup>

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<sup>29</sup>SBA interview, op. cit.

<sup>30</sup>SBA, SBA: What It Is . . ., op. cit., pp. 4-6.

<sup>31</sup>Ibid., p. 8.

<sup>32</sup>SBA interview, op. cit.

<sup>33</sup>SBA, SBA: What It Is . . ., op. cit., p. 21.

In recent years, the SBA has simplified and reduced the red tape involved in its transactions. However, the agency is still well organized and has written general loan policies and definitions that encompass most lending subjects. Subjects discussed under these general rules include collateral, guarantees, types of loans, the borrowers management, and financial statements and ratios.<sup>34</sup>

Most SBA loans and guarantees are serviced by the participating bank. Commonly the bank will set or recommend the majority of the term loan conditions. The practices and recommendations of the bank are respected and any differences in opinion as to what the terms and conditions of the loan should be are usually negotiated. Generally the SBA requires good collateral. If the borrower's collateral is weak and principals have substantial net worth, the SBA may request that each officer, director, and stockholder owning 20 per cent or more of the business, make a personal guaranty. However, in most cases, the problem of getting proper collateral is left up to the servicing bank.<sup>35</sup>

In Montana the SBA prefers not to make term loans with maturities of less than three years. The maximum

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<sup>34</sup>Small Business Administration, Collateral, Credit, and Other Factors, SC33/ND 510-1A 35 (June 24, 1971) (Mimeographed.), pp. 77, 83, 84.

<sup>35</sup>Ibid., p. 84; also, SBA interview, op. cit.

maturity is between 5 and 6 years in working capital loans and 8 to 10 years on equipment loans. Loans for newly constructed buildings can be for as long as 15 years. The average SBA loan in Montana has a maturity of 7 years and is for approximately \$63,000. The Montana SBA field office has over 900 loans on the books with most of these being guaranties.

The life of a loan is based on the type of business, growth potential, past history, net earnings, cash flow, and the rate of depreciation on assets pledged as collateral. There are two basic methods that the SBA uses to determine the repayment schedule and length of a loan. First, the portion of a loan for new equipment might be amortized over 5 years and at the same time the portion for a new building amortized over 15 years. The drawback of this method is that this forces the borrower to make heavy repayments on both plant and equipment early in the loan with lighter payments only after the equipment is paid for. The second method, which does not place such a heavy burden at the start of a loan when most borrowers are often least able to carry it, uses a weighted average of the different asset lives to determine a consistent repayment schedule over the life of the entire loan.<sup>36</sup>

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<sup>36</sup>SBA interview, op. cit.

### Financial Statements and Ratios

For proposed new businesses or the take-over of old businesses, regardless of the size of the loan, all borrowers are required to supply sufficient financial information to allow SBA loan officers to prepare cash flows and projected cash earnings for three years ahead. Even the interest savings between conventional financing and SBA financing is taken into account in determining repayment ability. Established businesses are required to provide income statements and balance sheets that go back a minimum of three years.<sup>37</sup>

Quick and current ratios are used to evaluate the adequacy of an applicant's working capital. The debt to net worth ratio is used, with consideration being given to the type of business and the firm's depreciation practices as well as to any trend in the ratio itself. Self liquidating debts such as floor planning and receivable financing are excluded from the computation of this ratio. Debts that are completely subordinate for the length of the SBA loan often are included as net worth. Generally, the SBA likes a debt equity ratio of not more than 2 to 1, or in other words, an owners' equity of at least one-third in the business. This ratio is watched over for the life of the loan. Inventory

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<sup>37</sup>Ibid.

turnover and the receivable roll are evaluated and watched. It is considered highly undesirable to have receivables outstanding for any longer than 35 to 40 days, and at 45 days, management will usually be required to improve the situation. The SBA also watches for significant changes or trends in sales, operating profits, expenses, receivables and inventory.<sup>38</sup>

The statistical studies of National Cash Register, Dun & Bradstreet, and Robert Morris Associates are used by SBA loan officers to compare the financial ratios and condition of a business to the averages for its industry.<sup>39</sup> In addition, the SBA places great emphasis on the competency of the borrower's management and the caliber, experience, motivation, health and age of the borrower's principals. Personal financial statements are required from principal owners and officers to determine whether any of the principals have assets that can be used in place of part or all of an SBA loan. Assets that are "locked in" and cannot be sold except at a substantial loss are not included in this evaluation.<sup>40</sup>

After a loan has been made, balance sheets and income statements are required at least annually. If a busi-

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<sup>38</sup>Ibid.; also, SBA, Collateral, op. cit., p. 82.

<sup>39</sup>SBA interview, op. cit.

<sup>40</sup>SBA, Collateral, op. cit., pp. 83, 86.

ness is new or has a poor track record, statements are often required on a semiannual, quarterly or even monthly basis. Receivables and payables must sometimes be aged monthly, and on occasion, receivables, payables, and inventories must be verified by an accountant. Financial statements must be prepared according to proper accounting methods, and on loans of over \$100,000 the year end financial statement must be audited.<sup>41</sup>

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<sup>41</sup>SBA interview, op. cit.

## CHAPTER IV

## TERM LENDING POLICIES AND PRACTICES

Questionnaire\*

Almost all of the surveyed Montana banks stated they have no written policies relating to term loans. The reason given was that there are too many variables. The few banks in Montana that do have written policies indicated that their policies are very broad, and cover such matters as loan administration, purpose, term and repayment.

Most banks indicated that they make term loans only within their immediate community, except through participations. Some of the larger banks in Billings, Great Falls, and Missoula, however, stated that they do extend term credits to borrowers from other communities. This is understandable because these large banks at times are the only ones that can properly service the term needs of borrowers from small communities. Sometimes when a loan is extended to a business outside the bank's community, it is done because the borrowing business' main office is in the same town as the lending bank.

More than half of the responding banks prefer term

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\*Appendix A.



loans to renewable short term loans when a borrower needs credit for longer than one year. Term loans are preferred because amortization is based on the repayment ability and needs of the borrower. Whether a term loan is preferred, depends in part on the nature of the borrower's business and the purpose of the loan. The character and reputation of the borrower, his success in the past, his prior dealings with the bank and his current financial condition are all important considerations. Similarly, the stability of the business over the intermediate term and its ability to use the loan for productive growth are important factors. The investment proposition must usually be within the scope of the borrower's operations and be capable of providing a significant contribution to profits. Loans are normally not granted for acquisitions that have nothing in common with the acquiring firm's operations and do not provide an adequate return on investment. Plant construction and expansion, equipment purchases, and additional permanent working capital are common purposes for term loans. These purposes include the funding of current debt or refinancing of long-term debt to improve some combination of working capital, terms of financing or anticipated maturities.<sup>42</sup> The

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<sup>42</sup>Douglas A. Hayes, Bank Lending Policies: Domestic and International, Michigan Business Studies, XVIII, No. 4 (Ann Arbor, Michigan: University of Michigan, 1971), pp. 107-108.

minority of respondents that prefer renewable short-term loans to term loans for financing long-term credit needs give two reasons for their preference. First, it allows interest rates to be adjusted to current levels. The rates on renewable short term loans are usually reviewed and changed annually as the notes mature. This appears to be a continuous process where the current cost of money and the borrower's financial condition are evaluated as each loan matures. If any circumstances have substantially changed, the interest rates and terms of the loan are renegotiated. Changes in short term interest rates are therefore easily implemented and affect only those new and renewed loans being negotiated when bankers think a change is in order. However, the need for the adjustment of rates because of a change in the general level of interest rates could be eliminated through the use of floating rates that change automatically with market rates. This would require less effort and conflict on the part of bankers and customers. A large number of Montana banks use floating interest rates in some term loan agreements. The fluctuating rate commonly is tied to the prime bank rate and no provision is made for a floor and a ceiling. The second reason given for favoring renewable short-term loans is that the renewal provides an occasion to annually review and discuss the progress of the loan and the borrower's business. At this time the bank can renego-

tiate the terms of the loan or refuse renewal. This reasoning may be questioned, however, because a bank is usually locked into a loan to a borrower who is deteriorating financially. The bank cannot be repaid when an insolvent borrower is unable to find financing elsewhere. It was also stated by the minority group of bankers that short term notes help maintain bank liquidity. But because liquidity is obtained primarily from short term marketable assets this argument is debatable. A better case for favoring short-term loans can be made by small banks whose deposits fluctuate quite widely. Normal levels of liquidity may not be adequate for these banks that find an abnormally high level of marketable short term investments necessary.<sup>43</sup>

Although 360-day notes are commonly used when term credit is granted through renewable short-term notes, 90 and 180 days maturities are the most popular on other short-term notes. Some banks have a policy of using demand notes for all, or some portion, of their short-term lending so that immediate payment can be required if conditions warrant. Douglas Hayes in his book, Bank Lending Policies: Domestic and International, states that term loans are an important part of the loan portfolios of large banks, accounting for as much as 30 to 40 percent of their total outstanding commercial loans. This proportion may be reduced slightly

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<sup>43</sup>Hayes, Bank Lending Policies: Domestic, op. cit., pp. 117-118.

during times of tight money when term loans--that tie up assets for longer periods--are screened more closely than short term loans. In Montana term loans have not yet reached as important a position in most bank portfolios. Term loans as a percentage of all business loans generally range from 10 to 20 percent, although a few higher and lower figures were reported. The use of term loans may increase in Montana as further acceptance and understanding of them is gained, but it is unlikely that they will ever represent as large a share of total business loans as they do in large banks which lend vast sums to national firms. The fact that all of the responding banks grant term loans to business customers makes it apparent that most Montana bankers have some familiarity with term credits. Over half of the respondents have total term loan investments in excess of one million dollars. Many of the smaller banks have term loan portfolios of \$500,000 to \$1,000,000. None of them have a ceiling limit on the total amount of term loans they will grant, and many do not believe that term lending has yet reached such a magnitude that its aggregate volume must be limited in some way.

Throughout the state, term loans are granted to all types of wholesalers and retailers in such fields as clothing, hardware, plumbing and automobiles. Doctors, dentists, architects, and other professional people are also recipients. Term credits are granted to all types

of manufacturers and processors, including lumber and wood products, meat packing, and concrete products. Furthermore, recipients include feed, grain, and storage firms and other agriculturally oriented businesses as well as recreational and lodging facilities. No bank reported that it made term loans to the mining or oil industries.

In Montana there is apparently little use of revolving credit term loans. Generally, it was reported that revolving credits have a maximum length of one year with possible renewal at maturity. The characteristics of these short-term revolving loans do not match those of true revolving credit term loans, inasmuch as the bank's commitment does not exceed one year, but to the extent that they are in fact renewed for a period of two to three years, they are a similar mode of financing. Several bankers mentioned that they use warehouse receipts from Douglas Guardian and Lawrence Warehousing as security for revolving credit loans and will lend a fixed percentage of the guaranteed inventory whenever desired by the borrower.

### Security

Banks prefer security on all loans if possible. But in cases where convenient collateral does not arise from the operation of the business or cannot be obtained at a reasonable cost, it is often waived. However, lower

interest rates can sometimes be negotiated on term loans with good marketable collateral than on similar unsecured loans.

With the responding banks, the percentage of business term loans granted on an unsecured basis ranged from none to surprising highs of 50, 75 and even 90 percent for a few of the larger banks. However, unsecured loans represented under 10 percent of the business loan portfolios of the majority of banks.

All banks reported that unsecured borrowers characteristically have a strong financial position with a large net worth, a low level of debt and high liquidity. In addition, the borrower must have proven management ability and a good prior history of loan repayments and income.

Nationally, large banks make the greatest dollar portion of their business loans on an unsecured basis. These loans in a sense are secured by a claim on the asset values and cash flows of a borrower. This claim is senior to the claims of stockholders, and with a top quality borrower, can be safer than the pledged collateral of a marginal borrower. Sometimes the market value of pledged collateral is not adequate to cover a loan if serious difficulties occur. Large banks normally make term loans to financially strong borrowers on an unsecured basis. But, banks generally require security on their term loans to borrowers of average financial strength for two reasons.

First, the fixed incidental costs of obtaining security is small in relation to the total income generated by the long length of these loans. In other words, the cost of obtaining the security represents a smaller percentage of the aggregate income of a term loan than that of a short term loan. Second, the length of term loans exposes them to many risks that make collateral advisable. The earnings and repayment ability of the borrower is vulnerable to such unforeseeable dangers as cyclical business fluctuations, competition and management problems.<sup>44</sup>

When Montana banks require security, real estate and equipment are the most popular types, with accounts receivable and inventories sometimes included as additional or secondary collateral. Several banks expressed a definite desire for liquid security and listed certificates of deposit, warehouse receipts, marketable securities and receivables as their preference. The actual security taken depends on the available assets, but commonly must hold sufficient value to cover the loan until maturity.

Douglas Hayes states that working capital loans are usually secured by accounts receivable or inventory. Receivables are normally preferred because their stated values represent actual claims on creditors.<sup>45</sup>

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<sup>44</sup>Ibid, pp. 129-131.

<sup>45</sup>Ibid, p. 132.

Aging schedules are usually required and only reasonably current receivables are accepted. Delinquent accounts that were due after 30 days and have remained unpaid for more than 90 days are customarily eliminated.<sup>46</sup>

Policies on loan commitments secured by receivables vary widely depending on the size, quality and number of accounts. Commitments usually are for 70 to 75 percent of receivables. However, if the accounts are those of a small number of high quality customers, commitments may go as high as 90 percent, whereas if the accounts represent many small customers of questionable quality, the commitment may be as low as 50 percent.

On loans secured by receivables, funds are usually advanced or repaid on a revolving basis as the level of acceptable receivables increases or decreases. If receivables increase, then the funds drawable on the bank increase up to the limit of the commitment, and if they decrease, pay-downs on the loan are required. Sometimes recurring audits are conducted to police receivables.

There are two methods of assigning receivables to the bank. The first and most popular method allows the borrower to use cash collections from receivables in the operation of the business. An adequate security margin is required, but the bank does not exert continuous control

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<sup>46</sup>Ibid., p. 132.



over the collection and replacement of the collateral.

The second method requires the borrower to deposit all cash collections in a "cash collateral" account with the bank. Withdrawals from this account are not allowed until proof is given that new accounts receivable have been generated. Loans covered by receivables commonly remain outstanding in fluctuating amounts for many years.<sup>47</sup>

Inventory is used to secure two types of loans. The first type usually finances the purchase, transportation, and storage of agricultural raw materials. These loans typically provide bankers a poor return because of high servicing costs. Special loan officers commonly must be assigned to take detailed care of such matters as proper warehouse receipts, insurance coverage, inspection of the collateral, hedging, and spoilage exposure.

The second type deals with securing the inventories of retailers and manufacturers. Chattel mortgages, field warehousing and floating liens are the collateral techniques that can be employed with these loans. A small number of units with high unit values is characteristic of the inventories secured by chattel mortgages. The main problems with this technique are those of insuring that legal technicalities are in order and that the items held under the chattel mortgage are accounted for.<sup>48</sup>

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<sup>47</sup>Ibid., p. 135.

<sup>48</sup>Ibid., pp. 137-138.

Field warehousing, because of its high cost, is economical only on large loans. It is commonly used where a large inventory, like that of a lumber company, must be stored on the premises of the borrowing business. The specialized services of Lawrence Warehousing, Douglas Guardian and other field warehousing companies facilitate administering the complex details of this collateral technique.<sup>49</sup>

The same general procedures used for receivable assignments apply to floating or continuous liens. However, receivable assignments and inventory liens are usually compatible only when both are held by a single lender. This is because floating liens on inventories have a superior claim to receivables and cash generated by the sale of inventory. Receivables pledged as collateral have only a subordinate claim. Therefore, most banks usually take a general and floating lien on both inventory and receivables or prohibit the borrower from pledging his inventory to other lenders.<sup>50</sup>

When stocks and bonds are given as security, funds are lent on only a percentage of their market value. This percentage varies with the security pledged, and for the different types, typically is as follows: Government bonds, 90%; Municipal bonds, 85%; Corporate bonds, 80%; Listed stocks, 60%; Unlisted stocks, 50%.<sup>51</sup> The market values of

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<sup>49</sup>Ibid., p. 138.

<sup>50</sup>Ibid., p. 139.

<sup>51</sup>Ibid., p. 142.

stocks and bonds pledged as collateral must be watched to make sure that loans are adequately secured. Additional or marginal collateral is usually required when values decline and coverage is inadequate.<sup>52</sup>

Montana banks gave "almost always" as the standard answer to the question of how often the guarantees of the principal shareholders are required in making term loans. Whenever a company is closely held, personal guarantees are normally required. Only a few banks do not require the guarantee or principals if the company's financial condition is strong. A limited number of firms have sufficient financial strength to be in this category. The purpose for this requirement is to prevent the assets of a borrowing business, claimed by a bank, from being reduced by principals through higher dividend and salary disbursements. This gives the bank a claim to the assets regardless of whether they are in the possession of the borrowing business or its owners.<sup>53</sup>

#### Interest Rates

The responding banks were asked to rank seven factors according to their importance in setting interest rates on term loans. They were also requested to list and rank any other factors that they considered. Below in de-

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<sup>52</sup>Ibid., p. 144.

<sup>53</sup>Ibid., p. 146.

scending importance is their ranking of the factors.

- (1) Financial condition of the borrower
- (2) Profitability of the borrower
- (3) Personal net worth
- (4) Type of business
- (5) Size of business
- (6) Rates charged by other banks

The banks disagree substantially as to the role of the prime bank rate in setting rate levels or influencing rate changes on new term loans. Most Montana bankers feel far removed from the big money markets and the affect of changes in the prime rate. Many disregard the prime rate and consider instead their cost of money. Bank liquidity is another factor considered by a few bankers as influencing term rates.

The spread between the interest rate charged a top quality borrower on a five year term loan and the rate charged the weakest acceptable borrower ranged from one percent to three percent. The most frequent spreads reported were from two to three percentage points.

Compensating balances are required by a few banks, but most think that the average collected balance of the borrowing customer is sufficient. When required, 10 percent to 15 percent is the usual compensating balance. Nationally, banks usually require supporting balances of 15 to 20 percent. Certificates of deposit are sometimes acceptable as partial fulfillment of the requirements for compensating

balances.<sup>54</sup>

A number of factors influence requirements for compensating balances. They include the negotiating power and growth potential of the borrower, as well as the amount of ancillary business the borrower conducts with other departments in the bank. Also of importance is the competition for loans and deposits.<sup>55</sup> One Montana bank that insists on compensating balances said that it has been able to introduce the concept to many borrowers during periods of tight money. When normal or competitive market conditions exist it is generally conceded that not all borrowers, especially small ones, will agree to maintain compensating balances.

#### Maturity

The majority of respondents were in agreement with banks nationally, expressing a willingness to make term loans for as long as seven years and with average lengths of between three and five years.<sup>56</sup> One bank further explained its willingness to make loans for as long as seven years by stating it only grants maturities of such length when they are guaranteed by the SBA. However, some banks will consider maturities of 10 to 12 years in special cases. Usually only top quality borrowers are granted the longer

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<sup>54</sup>Ibid., p. 95.

<sup>55</sup>Ibid., p. 196.

<sup>56</sup>Ibid., p. 112.

maturities. A small number of banks follow more conservative policies, and on the average, make term loans for only two to three years with an upper limit of five years.

Asset life and cash flow were the common factors cited as influencing the maturities of term loans. Close attention is also paid to the type of business, its past history and earnings and the purpose of the loan. Maturities are held to reasonable lengths in relation to the depreciating values of pledged assets. Adequate loan to collateral ratios must be maintained during the life of secured loans. The length of a term credit usually should be sufficient to allow a reasonable pay-off schedule relative to the borrower's cash flow and income. One Montana banker said that this is especially true in the case of unsecured loans. Apparently his thinking is that these loans must have realistic amortization schedules since there is no pledged collateral that can be sold, if necessary, to repay the bank.

Amortized payments are sometimes reduced by using balloon payments to defer a portion of the loan, perhaps 50 percent or more, to maturity. Term loans often must be refunded at maturity when balloons are used or amortization requirements are nominal, thus in effect making the loans long-term. Sometimes these "evergreen" credits are refunded at equal or larger amounts than originally. Bal-

loon payments are most justifiable if it appears the borrower can pay them when due.<sup>57</sup>

Slightly more than half of the reporting banks make term loans with balloon payments, but such loans account for a very small percentage of their total term loans. Two banks, one large and one of medium size, advised that 25 percent of their term loans have balloon payments. The maximum balloon as a percentage of the total loan is flexible, depending in part on whether it is secured or unsecured. If income and cash flow are higher than expected, a few banks sometimes require that principal payments be adjusted upward if a balloon is present.

The reporting banks evaluate the same sources of repayment as do banks nationally. Cash flow (i.e., net profits plus depreciation), long term borrowings, and the sale of fixed assets are considered in developing term loan repayment schedules.<sup>58</sup> The profits available for debt repayment are after deductions for dividends or owner withdrawals. In making cash flow projections sometimes information is used from income statements as old as five years as well as from proforma statements.

The banks disagreed as to whether or not depreciation should be considered when a term loan repayment schedule

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<sup>57</sup>Ibid., pp. 112-113.

<sup>58</sup>Ibid., pp. 105-106.

is developed. Most banks state that they do include depreciation and other noncash expenditures as sources for repayment. However, it was stated by one bank, that although noncash expenses are included in cash forecasts, the borrower should generate sufficient cash flow to service the debt without noncash expenses. Those who do not consider depreciation as a source of funds made the observation that funds equal to or greater than the amount of depreciation normally must be used to replace assets as they wear out and, therefore, depreciation should not be viewed as a source of funds for repayment.

It was unanimously agreed by the respondents that their term loan agreements do not normally provide for repayment penalties. A small number of banks on occasion include this penalty in agreements, but do not assess it on prepayments made from funds generated by the business or provided by the principal stockholders.

The surveyed bankers were asked if there is an unfilled need for business loans of from 3 to 10 years, and they replied that they do not see any evidence that this is the case. One banker argued that Small Business Investment Companies are looking for loans and also that if a need does exist it will be filled by insurance companies, which seems unlikely. The only dissent came from two loan officers who believe that some applicants for term loans are being turned



away by uninterested rural banks. One of these loan officers is from an agricultural area. Further evidence of this practice, if any exists, may not have been uncovered because small rural banks were not surveyed.

### Participations

The responding banks purchase more participations than they sell. This apparently means that these large and medium-sized Montana banks are purchasing more participations from small banks and banks outside the state than they are from each other.

Participations in loans originated by other banks account for 2 percent to 10 percent of most term loan portfolios, with extremes of zero and 20 percent. The responding banks only sell participations in 1 percent to 3 percent of the term loans they originate.

Participations are sold to other banks when the amount of the term loan exceeds the bank's legal lending limit. Some banks indicate that when this is the case, they sell only the amount by which the loan exceeds the legal lending limit. The purchasing bank usually does not require a compensating balance for its portion of the loan. The participations are usually purchased by affiliates and correspondents with loanable funds when the participations are good quality credits at attractive interest rates.

Participations are also purchased to maintain working relationships with banks so that they can be called upon for assistance when the situation is reversed. In addition, banks sometimes get together through term loan participations to service a mutual customer who has business locations in each bank's community. Occasionally a bank with excess funds will buy a participation in a term loan that has been outstanding for a time. Usually this occurs when the originating bank finds it desirable to sell portions of its loans because it is "loaned up" and has requests for new loans. Participations of this type are rare though, with most participations originating at the time the term loan is made.

The SBA is the most common non-bank lender that participates with Montana banks. Small business investment companies are also involved in participations, but only to a limited extent.

Most of the SBA participations are guarantees rather than immediate participations. The majority of banks reported excellent or satisfactory experience with the SBA program, and it was stated that any deficiencies in the program are rapidly disappearing.

SBA loans are commonly made to assist borrowers who cannot qualify for direct bank loans. Banks use SBA participations to limit risk in marginal loans, reduce exposure

from poor collateral, minimize investment in long-term credits and increase lending limits. SBA participations are often more desirable as investments than are participations with other banks or small business investment companies because they can be more easily resold if necessary.

It was indicated by the responding banks that they do not participate in term loans with insurance companies. This is not unusual, however, because participations with insurance companies are not popular on even a national scale. Banks do not like these participations because the possibility exists that the insurance company's long-term portion of the loan will become accelerated by involuntary technical violations of the term agreement by the borrower. This, of course, jeopardizes the bank's position in the loan. The conflict arises from differences in lending policies between banks and insurance companies. Banks generally are flexible in their lending policies and will change the terms of loan agreements to help borrowers through periods of financial trouble. Insurance companies, on the other hand, have distant and impersonal relationships with borrowers and usually will not frequently renegotiate the terms of loan agreements. This is because they are not interested in obtaining ancillary business from the borrower or continuing the relationship after

the loan has been repaid.<sup>59</sup>

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<sup>59</sup>Ibid., pp. 126-127.

## CHAPTER V

## FINANCIAL STATEMENTS AND INFORMATION

Most respondents require term loan applicants to provide financial information for the past 3 to 5 years, with only a few banks requesting only current information. The information desired normally includes balance sheets, income statements, and cash flow forecasts. These requirements are consistent with the policies of virtually all bankers.

On the other hand, the respondents are more lenient regarding the initial financial information required on short-term loans than are most banks. The surveyed banks want current income statements and balance sheets from most short-term borrowers, although some banks require only a balance sheet. One prominent bank also wants financial statements for the prior two years and an interim report less than 60 days old. However, most banks do not require interim statements on short-term loans because of their low reliability due to seasonable fluctuations, unaudited inventory estimates and lack of use by small borrowers. Nationally, requirements normally include balance sheets and income statements for three years and occasionally cash flow state-

ments, but less detail is usually required in financial information for short-term loans than for term loans.<sup>60</sup>

Past data is used to develop insight into the history of the applicant, its business cycle and any trends. A sharp lookout is kept for changes between statements that might signal a weakening financial position. An application should have a history of stable and sound finances over several years. A steady growth of sales and profits coupled with a good financial condition is most desirable. Bankers are dubious of customers with declining or erratic profit patterns. In making good term loans, future income and cash flows are more important as considerations than are assets.<sup>61</sup>

The majority of surveyed banks require cash flow forecasts from borrowers on new business, long-term and expansion loans. Cash projections are usually requested on the latter when proposed expansion entails a major change in the scope of operations and repayment is based solely on profits generated by the loan. The purpose of cash flow analysis is to prevent banks from being "locked in" by a situation where a borrower does not have sufficient cash to repay his loan except through liquidation. Some lenders will grant credit without cash flow analysis if existing

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<sup>60</sup>Ibid., pp. 82-83.

<sup>61</sup>Morton Bacher, Financial Reporting For Security Investment and Credit Decisions, NAA Research Studies in Management Reporting, No. 3 (New York: National Association of Accountants, 1970), p. 43.

income is sufficient to service the new debt or the borrower is qualified for unsecured credit. On the other hand, one bank stated it requests cash flows on all term loans over \$25,000.

Cash flow statements are normally prepared by the applicant or his accountant. Montana banks have sometimes prepared forecasts for borrowers, but the trend has been to require borrowers to present projections prepared by accountants. About the only time a bank will prepare the statement is after a loan has been made and it has turned out to be a poor loan or workout situation. Nationally, when cash flow statements are not provided, loan officers often prepare rough cash flows while screening the applicants. These statements are then completed by the bank's credit department.<sup>62</sup>

The responding banks usually do not require cash flow statements on short-term loans. When they do, analysis focuses on the revolving cycle of current assets and expenditures. The analysis for term loans is more extensive and considers the investment and conversion of all assets. This is because the assets of a borrower must have the ability to generate income and loan payments for many years. The contributions of depreciation and other non-cash expenses to cash flow are usually included in the analysis. It is

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<sup>62</sup>Ibid., p. 39.

important to have a large share of current assets in the form of financial assets because inventories do not always represent a readily available source of funds.

Montana bankers are aware of the limitations and weaknesses of cash flow projections. Many bankers carefully pointed out that a variance often develops between the actual operating results and cash flow projections. One bank stated that projections are only accurate for a maximum of about 16 months and should be adjusted quarterly.

All banks, including the respondents, require balance sheets and income statements from all term borrowers at least once a year during the life of the agreement.<sup>63</sup> On large loans or on problem loans they are sometimes wanted quarterly, semiannually or monthly. The financial statements for small loans are sometimes drawn up by the bank. Nationally, large banks usually want audited financial statements from most customers. The requirement of audited statements is almost universal on loans of over \$500,000. Smaller banks require audited statements on only a small portion of their loans, but in dollar amounts the percentage is big, because they require audited statements from most large borrowers. Many banks accept unaudited statements on loans of less than \$200,000.<sup>64</sup> The respondent

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<sup>63</sup>Ibid., p. 39.

<sup>64</sup>Ibid., p. 38; also, Hayes, Bank Lending Policies: Domestic, op. cit., p. 83.



banks are not as large as many banks in the country, and they require few audited statements because their loans are relatively small compared to those of the large banks. However, they do customarily require audited annual financial statements on term loans of over \$100,000. Also, the annual financial statements of marginal borrowers usually must be audited. The availability of other good credit information, the cost of the audits, the resistance of the customer to the requirement, and the need for audits are all factors in determining whether audited financial statements are required. Sometimes audits are not required when adequate collateral is provided.<sup>65</sup>

Some banks request that statements of consolidated income and retained earnings be provided, detailing adjustments to the surplus figures. Also, banks usually want to know the basis of asset valuations and depreciation determinations. Financial statements in which the public accountant's opinion is qualified because he did not observe the inventories or confirm the receivables are generally accepted on all loans but those where inventory and receivables are important collateral. Bankers sometimes make a physical inspection of inventories when they are used as collateral. It is a recommended policy that bank personnel visit a borrower's office or plant at least once a year to get a

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<sup>65</sup>Bacher, op. cit., p. 38.

general impression of the quality of the assets, character of management, and methods of operation.<sup>66</sup>

Reports from credit agencies, creditors, and customers are often used as references of creditworthiness. Creditors and customers can be determined by the names on checks deposited and drawn by the borrower. Inquiries must be circumspect to avoid possible repercussions on the borrower. Studies published by Dunn & Bradstreet and Robert Morris Associates are sometimes used to compare the financial ratios of borrowers to industry averages. Robert Morris Associates was the report most commonly cited by Montana bankers, but criticism brought out by one banker stated that the information provided does not always apply to Montana. There are limitations in the statement studies, but primarily they are caused by diverse accounting practices and corporate diversification that make comparisons difficult. Once these limitations have been discounted, the studies are useful everywhere, including in Montana. In addition, some banks supplement the statement studies by comparing the financial information of customers of similar size or industry. It was pointed out that careful consideration must be given to differences coming from comparisons to determine their importance.<sup>67</sup>

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<sup>66</sup>Hayes, Bank Lending Policies: Domestic, op. cit., p. 84.

<sup>67</sup>Bacher, op. cit., pp. 46-47.

In order to determine the extent to which Montana bankers analytically evaluate the financial condition and profitability of borrowers, they were asked to list and comment on the financial ratios they use. Financial ratios can express significant relationships and are an important part of financial statement analysis for credit purposes. Unfortunately the question on financial ratios was answered by just a little more than half of the reporting banks and several of these listed fewer than four ratios. The lack of response, as well as the reactions of loan officers interviewed personally by the writer, and frequency of brief answers, would lead one to believe that many bankers do not make extensive use of ratio analysis. Even on a national level the use of ratios varies greatly, with some banks using only a few key ratios.

The current ratio was the only ratio used by all answering banks and was more popular than the "quick" or "acid test" ratio, which was listed by a couple of banks. This is surprising since a large number of banks across the country normally prefer the quick ratio. It is usually popular because by excluding inventories it gives a better picture of the liquidity of borrowers. It is often difficult to realistically calculate the value and liquidity of inventories.<sup>68</sup>

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<sup>68</sup>Ibid., p. 43; also, Van Horne, op. cit., p. 641.

The second most widely used ratios are debt to net worth and inventory turnover. The amount of the owner's equity in the business can also be evaluated in the form of equity to total debt. In either form, intangible assets such as goodwill, prepaid expenses and deferred charges are usually eliminated prior to calculating this ratio to provide a margin of safety. The ratio reveals the financial leverage of the borrowing business, and thus its debt-paying capacity, and the size of the investment of the principals.<sup>69</sup> The inventory turnover ratio is commonly used, because it is an indicator of the liquidity of inventory. Perhaps it is popular in Montana because so many bankers also use the current ratio. The higher this ratio is, the more efficiently inventory is being turned over into receivables through sales. If the ratio is low, the inventory is moving too slowly, becoming obsolete, and of less value. Additional ratios are sometimes used to compute the turnover of different inventory categories in a detailed check for imbalances.<sup>70</sup>

Receivables turnover or sales to receivables is next in popularity and customarily used along with inventory turnover. This ratio reveals the turnover of accounts re-

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<sup>69</sup>Van Horne, op. cit., p. 645.

<sup>70</sup>Ibid., p. 644; also, Bacher, op. cit., p. 43.

ceivable in relation to sales, the liberalness of credit policies and the potential for bad-debt losses. Additional ratios are also used to evaluate receivables when their use appears necessary.<sup>71</sup> Return on capital is an equally popular ratio in Montana and one that is commonly used by bankers everywhere. It indicates the efficiency of a business for its owners by relating the profits of the business to the book value of owners' equity. If market value is used instead of book value the result is an earnings/price ratio. The higher the ratio, the more profitable the business. The debt leverage of the business must be checked when this ratio is used because high levels of borrowing can increase the ratio.<sup>72</sup>

Next in popularity is the average collection period of receivables. This ratio is the inverse of the receivables turnover ratio. The number of days in the year divided by the turnover ratio gives the average collection period. If these two ratios are counted as one they become as popular among Montana bankers as debt to net worth and inventory turnover. Both ratios reveal about the same thing, with perhaps the average collection period of receivables being more meaningful. The third measure of receivables liquidity, the aging of accounts receivable, was mentioned

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<sup>71</sup>Ibid., p. 642.

<sup>72</sup>Ibid., p. 648.

by only one bank.<sup>73</sup>

Accounts receivable to accounts payable, fixed assets to net worth, total debt to total assets and the percentage of earnings retained, were also mentioned by a limited number of banks.

A number of ratios not listed by respondent banks but commonly used by banks nationally includes: Gross operating profit as a percent of sales (gross profit margin); net operating profit as a percent of sales; net operating profit after taxes as a percent of sales (net profit margin); sales to net worth (equity turnover). These ratios are useful in evaluating profitability in relation to sales and sales relative to net worth. Used together they provide considerable insight into the operations of a borrower. Other ratios that are popular with many banks other than the respondents are days' supply of inventory on hand and days' purchases in payables.<sup>74</sup>

Some of the respondents only evaluate the financial condition of borrowers with the current ratio and one other measure like debt to net worth or total assets to total liabilities. Those who routinely use four or more ratios place as much emphasis on cash flow and repayment ability as they do on the borrower's collateral and net worth. These banks realize that a ratio is only an index and must have a basis

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<sup>73</sup>Ibid., p. 642.

<sup>74</sup>Bacher, op. cit., p. 43.

for comparison. They not only use ratio analysis to compare the borrower to other businesses, but also to evaluate the borrower's past statements, pro forma statements and financial position immediately after the loan.

Nationally, bankers are not always satisfied with the financial information provided by statements prepared by CPA's. They state that many CPA firms are not sufficiently qualified in management services to recognize the need for better management information systems, and therefore provide inadequate information.<sup>75</sup> In general they complain of too little detail, undisclosed material items and failure to adequately describe accounting methods. These areas must be adequately reported if banks are to make meaningful comparisons and evaluations. Repeated complaints are voiced in regard to the lack of detail in operating costs and results, consolidated financial statements, aging and concentration of receivables and payables, of balance-sheet liabilities, inventory data and the breakdown of fixed assets.<sup>76</sup>

The responding Montana bankers do not register these complaints and happily report that the quality of financial information supplied by business borrowers has improved substantially in recent years. Larger credit needs necessitat-

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<sup>75</sup>Ibid., p. 57.

<sup>76</sup>Ibid., pp. 58-60.

ing more complete information and the increased use of CPA's has contributed to this improvement. In addition, more businesses are recognizing that good accounting practices are a management tool for achieving goals.

The bankers think that the quality and detail of financial information supplied by accountants is satisfactory. Their only complaint was that they wished accountants were faster in preparing reports after the accounting period. The delay generally runs from two to three months for annual reports, one month for quarterly statements, and between 10 and 14 days for monthly reports.

Reporting bankers stated that by themselves financial statements are poor decision-making tools. There are a host of factors not covered by financial statements which must be considered in evaluating loans. Financial statements, for example, cannot reflect the character and competence of the borrower or the market of the business or industry. In addition, they reflect the borrower's financial picture for only one day. Business conditions change fast and inventories can be old when statements are received.

Balance sheets and operating statements for many years must be analyzed to give insight into the real position of the borrower. Often asset values listed do not coincide with current market valuation and small borrowers



can sometimes manipulate the balance sheet by moving ownership of assets back and forth between the business and the principals. Furthermore, detailed financial information is sometimes difficult to get from small firms that do not understand accounting or its importance. Also, these borrowers usually are not thinking in the same terms as the accountant or the bank.

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Small Business Administration. Interview with the Loan Officer at Montana SBA Field Office, July 1972.

## APPENDIX A

University of Montana  
Graduate School of Business Administration  
Questionnaire

PURPOSE OF QUESTIONNAIRE

The purpose of this questionnaire is to gather information about the policies and practices of Montana banks in the areas of business term loans and the financial statements and information required from borrowers of all types of business loans.

DEFINITION OF BANK TERM LOAN

For this study a term loan is defined as a business loan made pursuant to a term loan agreement, with a maturity of over one year and with repayment tied to a specific schedule. A revolving credit with a commitment for a period in excess of one year is considered a term loan, whereas an installment equipment loan is not considered a term loan.

TERM LOANS

1. Does your bank make term loans to its business customers?
2. When a business borrower needs credit for more than one year, do you prefer to extend a term loan or a renewable short-term loan? Please explain why?
3. Are your renewable short-term notes to business borrowers normally demand notes, 90 days notes, one year notes or other?
4. Approximately what percentage of your business loan portfolio is comprised of term loans?

(No. 4 continued next page)

4. continued
  - A. Originated by your bank?
  - B. Originated by other banks?
  - C. To what extent do other banks participate in term loans originated by your bank?
5. What is your present total investment in business term loans, approximately?
6. Do you have a ceiling limit on the total amount of term loans outstanding? If so, how is this ceiling determined?
7. Do you maintain amortization schedules to show your current term loan position?
8. Do you make term loans only within your immediate community?
9. To what kinds of business firms are most of your term loans made?
10. To what extent do you make revolving credit term loans?
11. Does your bank have any written policies relating to term loans? If so, please outline briefly what they are.
12. About what percentage of your business term loans are unsecured?
13. What are the characteristics of your unsecured term loan borrowers as compared to borrowers who are required to provide security?
14. What types of security do you prefer on term loans?
15. How often do you require the guarantee of the principal shareholder or shareholders in making term loans?
16. What is the longest term loan you will make? The average length of your term loans?
17. What influences the length of the term loans you make? e.g., asset life, cash flow, bank policy, etc.
18. What percentage, approximately, of your term loans have balloon payments? What is the maximum balloon as a percentage of the total loan?

19. When there is a balloon payment, does the loan agreement require larger principal payments in periods of higher profits?
20. What source or sources of funds do you consider when developing term loan repayment schedules? For example, do you generally consider depreciation as a source of funds? Why or why not?
21. Do your term loan agreements provide for prepayment penalties? If so, under what circumstances do they permit prepayment with funds borrowed from another lender?
22. Indicate the relative importance of the following factors in setting the interest rates on term loans. Please rank them 1 through 8.
  - Prime bank rate
  - Size of borrower
  - Financial condition of borrower
  - Profitability of borrower
  - Type of business
  - Rates charged by other banks
  - Personal net worth of borrower
  - Other (please specify)
23. Do you sometimes use floating interest rates in term loan agreements? If so, is the rate tied to the prime bank rate? And, does the agreement provide for a floor and a ceiling on the rate?
24. On what percentage of term loans do you require compensating balances? Is there any type of borrower that will not agree to a compensating balance?
25. What is the usual compensating balance requirement (as a percentage of the total loan or the unpaid balance of the loan), and over what period of time is it averaged?
26. Are compensating balances sometimes in the form of time deposits?
27. Under what circumstances does your bank find it attractive to participate in term loans originated by other banks?

28. Does your bank ever buy a participation in a term loan from another bank after the loan has been outstanding for a time? How do these transactions usually originate?
29. Do you require a compensating balance when participating in a loan originated by another bank?
30. How often do you participate with non-bank lenders? Please list the non-bank sources of participation that you use, e.g., insurance companies, SBA, small business investment companies, etc.
31. What has been your general experience with SBA participations and guarantees?
32. Do you believe there is an unfilled need for business loans with maturities of say, three to ten years?
33. Do you believe that the SBA lending programs are deficient in any respect? If so, how?
34. Do you promote SBA loans, participations, and guarantees? If so, for what reasons?
35. At any given time, how wide is the spread between the interest rate you would charge a top quality borrower for, say, a five year term loan and the rate you would charge the weakest borrower to whom you would be willing to extend a term loan?
36. Do you change your rates for new term loans as the prime bank rate changes? If not, how do you decide when to change the rates?
37. How often do you review and change the rates on renewable short term loans to business firms?

#### FINANCIAL STATEMENTS

1. Does your bank have any definite policies, written or unwritten, regarding financial statements required from business borrowers? If so, please outline briefly what they are.
2. Has the quality of financial information supplied by business borrowers improved in recent years? If so, in what respects?

3. What kinds of financial statements and information do you require for short-term business loans? Do you require more information for term loans and, if so, what?
4. How far into the past do you require financial information from business loan applicants?
5. On what kinds of business loans do you require cash flow forecasts? What problems have you experienced with cash flow statements?
6. Who generally prepares the cash flow statement? Does the bank ever prepare cash projections for loan applicants, and if so, under what circumstances?
7. Will you make term loans without cash flow forecasts, and if so, under what circumstances?
8. What financial ratios do you use in evaluating business loans? Term Loans? Please comment on which ratios you consider most important and why.
9. What comparisons do you make of the borrower's financial ratios with the ratios of other firms or the borrower's industry? Do you, for example, use the information in the Annual Statement Studies published by Robert Morris Associates, and if so, how?
10. How often do you require business borrowers to submit financial statements? Under what circumstances must the statements be audited?
11. Will you accept a qualified statement where the public accountants have not observed the inventories or confirmed the receivables? On what types of loans will you not?
12. How soon after the accounting period must annual statements from borrowers be received? Quarterly statements? Monthly statements?
13. In general, in what respect do you find that financial statements are a poor basis for making decisions?