

The legal and accounting facts behind getting a loan

Business owners need to thoroughly review information and calculation of certain financial ratios

Most businesses should seek to establish a relationship with a lender. Here is a discussion of some factors involved in originating and maintaining a loan.

CPA: Two of the most common types of business loans are a line of credit and term debt, either of which may be secured or unsecured, or guaranteed by the SBA.

Term debt refers to a lump-sum loan repayable in installments. A line of credit, on the other hand, is drawn down in increments, as needed and repaid as the business is able. Some lines of credit may impose a borrowing base restriction, which limits the outstanding loan balance at any time to a percentage of the current accounts receivable and inventory.

Lenders usually require that financial statements and tax returns for the most recent three years, a current financial statement, and a business plan accompany a loan application. Review of this information and calculation of certain financial ratios by lenders establishes the business's current and projected profitability, and determines whether sufficient cash flow will exist to enable repayment of the loan.

Lenders frequently ask for personal financial statements and the last three years' income tax returns of the business owners as well, to allow them to determine the ability of the owners to repay the debt if the business cannot.

ATTORNEY: The business owner should understand all of the loan elements, including origination fees, interest rate, term of loan, and the frequency and

amount of payments. The origination fee is usually based on a percentage of the loan amount, which may be higher than the line of credit available to the business if a borrowing base restriction exists. The interest rate may be fixed or fluctuate over time, typically by reference to a prime lending rate.

Some loans are interest only, with the principal due at a fixed date, others are amortized over the term of the loan, and yet others are amortized over a longer period (allowing smaller payments), with a balloon payment at the end of the term. In addition to seeking security for the loan, lenders frequently require a personal guarantee, making the owner personally liable if the business defaults on repayment. Special attention should be paid to loan document provisions that set forth the events of default.

CPA: In addition to failure to make payments when due, other actions or conditions may place the borrower in default. Loan covenants may require the lender's permission for owners' compensation and capital expenditures above a certain limit, or may require that certain financial ratios be maintained, that financial

and tax information be provided on a timely basis, that minimum insurance levels be maintained, and that the business comply with all applicable laws and regulations.

These financial ratios will usually be the same ones that the lender used in approving the loan, and include the current ratio, the debt-to-equity ratio, and the minimum debt service charge.

The current ratio generally required is 2-to-1 (current assets being double current liabilities) and the debt-to-equity ratio should not exceed 3-to-1 (total liabilities should not exceed three times the owners' equity in the business).

ATTORNEY: The loan agreement should also specify the lender's remedies upon default, including a time period in which the borrower can cure the default.

Except in rare circumstances, the lender will not be allowed to sell the business's assets without proper notification and a period of time in which to object.

Lenders almost always respond better to a business that has an established relationship and is honest and forthcoming about its situation. This will be true in the initial loan application as well as later, if trouble develops. As in most business situations, the upfront, honest approach usually pays off.

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