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Bank loan presentation

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The Bank Loan Presentation

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Bank loans constitute a major source of outside financing, particularly for smaller businesses. An important aspect in obtaining this type of financing is the loan presentation, which unfortunately is not always given the careful consideration and preparation it deserves. This is particularly true when the company is making its initial contact with a bank.

The purpose of this paper is to develop the essential ingredients for an effective loan presentation.

Proposals to security underwriters and other sources of outside financing contain most of the elements of the bank loan presentation. Many of the comments also have relevance to "insider" presentations to top management who may be considering the allocation of corporate resources among a number of investment alternatives.

WHY A GOOD PRESENTATION IS IMPORTANT

The loan proposal is largely a selling effort by management designed to assist bank officials in judging the desirability of making the loan and in evaluating the relative degree of risk involved. The loan presentation has three primary objectives:

1. It should outline the reasons the financing is needed and what management expects to accomplish with the funds.

2. It should project the future operations of the business to help evaluate the ability to repay the loan.

3. It should exhibit management's talents and professional abilities.

Considering these objectives, it is obvious that the relative quality and completeness of the loan presentation can have great influence in determining whether the loan will be granted. This decision is even more critical in a tight money market. It is also apparent that the proposal will be a factor in determining the degree of risk and consequently the interest rate. The effectiveness of the presentation can also influence the relative severity of loan agreement terms such as maintenance of specified amounts of working capital or equity, restriction on the payment of dividends, limitation of officers' compensation, types and amount of collateral, and requirements for personal guarantees by owners.

If the loan is to be secured by accounts receivable and/or inventory, it is common for a bank to require monthly submission of aged trial balances of accounts receivable and to insist on periodic physical inventories or other types of inventory tests. Other burdensome and costly procedures frequently required include field warehousing of inventories and confirmation of customers' accounts. A proper loan presentation emphasizing the strength of the company's accounting procedures and internal control system, and disclosure of the use of an audit by independent accountants, can eliminate or reduce some of the obstacles.

These more significant factors of bank financing influenced by the loan proposal illustrate the importance of a good presentation.

Of equal importance, preparation of the loan presentation will assist management in evaluating the proposed financing. Insistence on a quality package will force a rigorous examination of the company's past and present performance and future plans.

WHAT CONSTITUTES AN EFFECTIVE LOAN PRESENTATION

The type and size of loan, credit rating of the borrower, and the bank's familiarity with the particular business will be major factors in determining the structure of the loan presentation and the amount of detailed information presented. However, in any banking relationship, most, if not all, of the information subsequently discussed will have been furnished to the bank at one time or another. Here are some general rules for format and organization:

1. The proposal should be typed or printed on quality paper and bound in booklet form.
2. Financial information should follow a logical sequence with detailed information summarized.
3. Visual aids such as charts and graphs should be used wherever possible.
4. The oral presentation accompanying the proposal should obviously be made by an articulate individual who is knowledgeable about the company and the financial information contained in the proposal.

A presentation generally consists of two distinct but interrelated parts: the narrative section and the financial statements and statistical data.

REQUIREMENTS OF THE NARRATIVE SECTION

The loan presentation should include a description and history of the business and its management. Biographical sketches of important management personnel would quite properly be included since an evaluation of management's professional ability is very important to progressive loan officers. In addition, if the loan is being made to a closely-held business, amounts of life insurance and summaries of personal financial condition of owner-officers should be included.

The purpose of the loan should be discussed in some depth. Such a discussion would include the proposed uses of the funds and how such financing fits in with management's short- and long-range plans. These plans and forecasts of future operations and financial condition must be based in part on certain assumptions. These assumptions should be discussed in detail with particular emphasis on those on which financial forecasts are based. It is important that any major business problems be brought into the open because it is natural that they can be considered in perspective at this time. Their discovery by the loan officer at a later date can cause a much more serious problem.

It is also good strategy to include assumptions regarding the proposed loan such as repayment terms, interest rate, refinancing procedures, financial information to be periodically furnished by the company, etc. This is proper since management naturally has its own ideas on what financing arrangements are necessary and best for the business. It also provides a starting point for later negotiation with the bank.

The crucial test of the narrative section of the presentation is whether the loan request can stand on its own merits without further oral explanation. If the text leaves a tentatively favorable impression in the reader's mind without raising questions or objections of major importance, it has accomplished its purpose.

FINANCIAL INFORMATION REQUIREMENTS

Financial statements covering a reasonable period of the company's history should be included. It is obvious that certified financial statements will be more readily acceptable to bank officials than unaudited statements and, in fact, may be required as part of the loan agreement. If audited statements are not available, copies of federal income tax returns may be included. Any significant changes shown in the statements should be fully explained. If the information is of considerable bulk, it may be summarized in the presentation although complete copies should be given to the bank.

When the loan is to be secured by various types of assets, financial information with respect to such assets should be included. In the case of accounts receivable and/or inventory financing, historical turnover ratios showing the time period required for conversion of these assets to cash are useful. A list of customer accounts should be prepared with description of the type of customer and billing terms along with analysis of bad debt experience and a current aged trial balance of receivables. If the loan is based on a mortgage, a copy or summary of an appraisal report by a recognized independent appraisal engineer is desirable as well as a summary of types and amounts of insurance coverage.

Probably the most important information contained in any loan presentation and the most difficult to properly prepare is the various financial forecasts. If the increasingly popular term loan is the financing vehicle, this information is even more important since this type of loan is based on the borrower's projected ability to generate cash. The period covered by such forecasts should at a minimum coincide with the term of the loan although it is often sufficient if detailed forecasts are prepared for shorter periods, with condensed information for periods further in the future. Detailed statements of cash flow, net earnings, various major expense categories (i.e., selling, manufacturing, general, and administrative), and detailed balance sheets are necessary. Forecasts of sources and applications of working capital can provide meaningful information and will assist in "tying" together the other statements included in the loan presentation.

Numerous articles have been written on the techniques of forecasting operations, cash flow, and financial position, and while this subject will not be explored in depth, some basic methods of approach can be briefly outlined. The certified public accountant can be of real service to the client considering bank financing since his working papers may contain much of the necessary information. In addition, this professional will probably have considerable experience in forecasting techniques and in putting loan presentations together.

The first forecasts developed should project operations and financial condition to the end of the current fiscal year. All of the forecasts for each successive year should be developed together. Much of the data will be developed from historical information, and it is highly recommended that two or more years of historical financial data be included in comparative form with the projected financial statements. If the company has used highly developed forecasting and planning techniques in the past, the forecasts for prior years might be included for comparison with actual results as another indication of management's abilities and realistic approach. Disclosing the successful use of forecasting and profit planning cannot help but add to management's professional stature.

If the purpose of the loan is to finance a new venture, the starting point would be the financial position showing initial equity investment, proceeds of bank financing, and the investment of these funds.

The forecasts for each year can best be developed in the following sequence:

FORECAST OF OPERATIONS — This forecast is probably the logical starting point in preparing the projections for the loan presentation. Sales amounts should be based on firm assumptions such as professional market forecasts or an extension of the company's sales trend. Obviously, the inclusion of any industry-wide forecasts that support the company's projections will lend considerable weight to the loan presentation. If sales and production are based on job contracts, the sales projection should be supported by a listing of individual contract amounts and delivery schedules. Information on sales backlog is important and should be included in the report. Some discussion of theoretical and practical capacity is also desirable since it enables the reader to evaluate the reasonableness of management's forecast revenues.

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Forecasts of cost of products sold will, in most instances, be based on historical gross profit percentages. In cases where historical information is not available or is not valid for future periods, cost buildups by element (labor, material, manufacturing overhead) will accomplish the same result. If such cost buildups can be supported by a standard cost system using engineered standards, so much the better.

Detailed statements, by natural expense classification, should be prepared to support projections of manufacturing overhead costs and of selling, general, and administrative expense. Ideally, such expense forecasts are founded on good budgeting procedures; however, in most cases, historical information, appropriately adjusted for anticipated levels of operations, is adequate.

Projected depreciation expense should be based on a realistic capital expenditure program while interest expense should be forecast based on assumptions made in the loan presentation as to interest rates and repayment terms.

CASH FLOW PROJECTIONS — The format most frequently used for a statement of cash flow is to start with forecast net earnings, adjusting the earnings for non-cash operating items such as depreciation and non-operating sources or applications of cash such as long-term financing and capital expenditures. Clearly, this projection should agree with other sections of the loan proposal with respect to loan repayment proposals, future capital expenditures, other debts, dividend requirements, etc. Of a more subtle nature are effects on cash balances of items such as proposed changes in invoicing terms, increased utilization of suppliers to provide working capital, or plans for increasing or decreasing inventory levels. If turnover ratios relating to elements of working capital change from historical patterns, as between periods in financial forecasts, the effect of such changes must be considered in cash flow projections.

PROJECTED BALANCE SHEETS — Although the term loan primarily requires analysis of the ability to generate cash and thus repay the loan, bankers justifiably are concerned with the future financial stability of the business as shown by projected balance sheets. This fact alone would warrant their inclusion in the proposal. In addition, the projections of financial position can be said to be the test of the accuracy of the other forecasts. The cash position, net earnings, and earnings retained in the business, capital expenditures and related depreciation, and changes in the relationship of working capital items have previously been developed. Consequently, if the individual items cannot be summarized in balance sheet form and total assets and liabilities agreed, it probably means incongruous assumptions between the different forecasts or mathematical error.

As an additional check, accounts receivable, inventory, accounts payable, and accrued liabilities must bear reasonable relationships to historical turnover ratios when considering projected volume and changes in policies and procedures. Obviously, if for good reason such relationships are invalid, appropriate explanations and analysis should be included with the forecasts and such reasoning should carry through all the projected statements. In the instance where historical data is not available, as in the case of a new enterprise, use of trade or credit association statistics is a recommended and defensible procedure.

If forecasts differ significantly from the current financial situation or material changes in the forecasts occur from year to year, detailed explanations outlining the basis for such changes should be attached.

On the whole, it seems advisable to be conservative in preparing forecasts. Unguarded optimism will undoubtedly raise questions as to the validity of the projections during consideration of the loan proposal and could be embarrassing when actual results become available.

The presentation should include any other information useful in appraising both the ability to repay indebtedness and the realism and objectivity of management. For example, profit and loss break-even charts and a cash flow break-even chart are particularly useful. It is natural that projections of earnings and cash flow, even though apparently conservative, are subject to challenge. If the loan officer can see a significant range between anticipated results and break-even points, it will undoubtedly provide a certain amount of comfort. When financing is sought for new products, market development, or expansion of facilities, summaries of marketing or feasibility studies should be included in the loan presentation. The bank will generally require a copy of the complete study.

If the funds are allocated to a number of uses, information must be developed for each investment as well as in summary form. The use of return-on-investment calculations would be a welcome addition in analysis of loan proposals of this type.

If the financial information section of the loan is effectively presented, it will clearly and logically lead the reader from the financial position of the business at some historical date to a conservative forecast of its financial position in the future. The projected results for periods between these points should leave no doubt, by any measure, as to the ability of the business to generate the necessary cash for orderly growth in an expanding economy and to repay the loan.

REVIEW THE COMPLETED PROPOSAL

The final step in preparation of the loan presentation is the review of the complete document. This procedure preferably will include a complete "dry run" with members of management who have not participated in the detailed preparation of the report. The independent certified public accountant can render valuable service through vigorous review and challenge of the document, particularly the financial forecasts. The review procedure, if properly formalized, will insure that the three major objectives of the loan proposal outlined earlier have been accomplished. It will also expose inconsistencies or the lack of necessary information. A good loan presentation should minimize the amount of additional information requested by the loan officer.

SUMMARY

The keen competition for bank loans in the amounts and at the terms desired has made borrowing money a major business decision for both the lender and borrower. A thoughtful, well-prepared loan presentation will invariably speed up the loan process as well as smooth potential obstacles and may be of vital significance to both parties in arranging the loan and establishing a sound future relationship.