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# Preparing Your Company for the Next Level

## Obtaining Bank Financing/ Financial Reporting and Accounting

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# INTRODUCTION

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Any record-keeping system that you choose should help you run your business. Your system should be simple to run and simple to understand. It should help you analyze the business by showing you where you are now and where you'll be in the future. And you'll want a system that keeps all of the necessary information for your records, whether for payroll or taxes, inventory, accounts receivable or payable, or cash flow.

A good record-keeping system may even help you increase your profits.

# INTRODUCTION

You can decide whether to keep your own books or hire a professional to do it for you. Most small business advisors suggest that you have a certified public accountant prepare your tax returns and year-end statements.

Certified public accountants will also offer advice on various aspects of financial management, such as cash flow analysis and borrowing needs for the business.

# INTRODUCTION

- Accurate and current financial information is important to obtaining bank financing
- Used to determine current and future cash flow and financing needs, both short term and long term
- Review previous history and budget or projections to determine the best type of financing for your business
  - Line of credit (evaluated for renewal periodically or annually, used for working capital and short term inventory and accounts receivable needs)
  - Short-term commercial loan (usually one – five years, used for equipment or longer term inventory or specific project needs)
  - Long-term commercial loan (five years and longer, used for major equipment, improvements, or needs required by buy-sell agreements)
  - Commercial mortgage (available for real property purchases)

# INFORMATION YOU MAY NEED FOR THE LOAN

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- **Company Information**

- Business plan and/or budget (make sure you give a summary of assumptions used)
- Loan application (if required by the bank)
- Tax returns for the past three years
- Past three years of financial statements (prepared by your certified public accountant, or accurate internal statements if you do not have statements by your CPA at this time)
- List and value of collateral
- Accounts receivable aging (listed by date of invoice - be sure to note any special terms for significant balances which are in compliance with industry practices)
- Accounts payable aging

# INFORMATION YOU MAY NEED FOR THE LOAN

- **Company Information**

- Be prepared to give the banker a tour of your business
- Show current processes or equipment
- Explain how new process or equipment will improve company profits (your certified public accountant can help prepare or review this analysis)
- Resumes of key management team members
- List of your company's team of advisors (board of directors, attorney, certified public accountant, insurance provider and banker)

# INFORMATION YOU MAY NEED FOR THE LOAN

- Personal Information
  - Tax returns for the past three years
  - Current personal financial statement
  - Bank may also look at your personal credit history
  - Information is needed as the bank may require personal guarantee

# COMPANY STRUCTURE

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- Sole Proprietorship
- Limited Liability Company
- Partnership
- C Corporation
- S Corporation

# COMPANY STRUCTURE

- Structure may determine additional information needed
- May need personal information for anyone with ownership in excess of certain %
- Structure may determine if information or guarantee is needed from your spouse
- Review other impact of legal status with your attorney

# ONGOING REPORTING REQUIREMENTS

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- Review the reporting requirements in the loan document with your certified public accountant and your attorney **BEFORE YOU SIGN THE DOCUMENT**
- Information usually required
  - Tax returns – both business and personal
  - Financial Statements
    - Audit
    - Review
    - Compilation

## • Financial Statements

- Audit - an intensive and objective examination of your financial records, with the highest level of assurance
  - Auditor gives an opinion
  - Most expensive service level
  - Owner and management must still offer representations
- Review – includes inquiry and applying analytical procedures to the financial statements, with negative assurance
  - Owner and management must offer representations
- Compilation - report based on client-supplied information, no assurance
  - If prepared with no disclosures primarily for internal use

- Financial Statements – Accounting Basis and Reporting
  - Generally Accepted Accounting Principles (GAAP) –accrual basis, even though this is standard may not be best option. Ask your accountant.
  - International Financial Reporting Standards (IFRS)- may be required if you are affiliate of international company
  - Other Comprehensive Basis of Accounting (OCBOA)
    - Income tax basis (accrual or cash basis)
    - Cash basis
    - Modified cash basis
  - For Compiled financial statements, management may omit substantially all disclosures (required by GAAP or OCBOA)

- Loan Covenants - Make sure they are meaningful to your business
  - Distribution - limits owner salaries and cash distributions to cover income taxes
  - Restrictive - limits obtaining additional loans from other sources
  - Shareholder loan subordination
  - Minimum net worth, working capital and/or limit on equipment spending
  - Debt-to-Equity Ratio =  $\text{Total Liabilities} / \text{Total Equity}$  - indicates capitalization
  - Debt Service Coverage Ratio =  $\text{EBITDA} / (\text{Prior Period Current Period Long Term Debt} + \text{Interest Expense})$

- ## Sample Audit Report

Independent Auditors' Report

Board of Directors  
ABC Company

We have audited the accompanying balance sheet of ABC Company (Company) as of December 31, 2010 and 2009, and the related statements of income, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Firm's signature

City, State

The Date of the Auditor's Report

February 15, 20X2

# ONGOING REPORTING REQUIREMENTS

- ## Sample Review Report

Independent Accountants' Review Report

Board of Directors

ABC Company

We have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20x2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. [A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.](#)

[Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.](#)

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

[Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.](#)

Firm's signature

City, State

The Date of the Auditor's Report

February 15, 20X2

# ONGOING REPORTING REQUIREMENTS

- ## Sample Compilation Report

Independent Accountants' Compilation Report

Board of Directors  
ABC Company

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. [We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.](#)

[Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.](#)

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. [The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.](#)

Firm's signature

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- ## Most Common Revenue Recognition Methods

**Accrual** – recognize revenue when earned, recognize expense when incurred.

Generally, manufacturers, restaurants, construction contractors, etc. report on the accrual basis.

**Cash** – recognize revenue when received, recognize expense when paid.

Generally, service type businesses such as doctors, attorneys, consultants, etc. are cash basis.

Also, size and reporting requirements of entity may also effect acceptable revenue recognition methods.

For tax purposes, the method must clearly reflect income. An accounting method will not clearly reflect income unless items of gross income are treated consistently from year to year.

For tax purposes, the accrual method is generally required if the taxpayer purchases and sells inventory. However, there is an exception for small taxpayers with average annual gross receipts less than \$1 million. There is also an exception that allows taxpayers with annual gross receipts of \$10 million or less to use the cash method if the business is primarily a service-type business.

For financial accounting purposes, the accrual basis is generally accepted. (GAAP) If financial statements are prepared on the cash basis, this is another comprehensive basis of accounting.

## Other Key Ratio Formulas

- Current Ratio = Total Current Assets / Total Current Liabilities – measures liquidity, 2 to 1 is considered favorable, usually the higher the better
- Quick Ratio = (Cash + Accounts Receivable) / Total Current Liabilities – removes inventory and other assets from above ratio
- Gross Profit Margin = Gross Profit / Sales
- Net Profit Margin = Adjusted Net Profit Before Taxes / Sales
- Inventory Days = (Inventory / COGS) \* 365 – indicates how many days of inventory you have on hand, should not be too high
- Accounts Receivable Days = (Accounts Receivable / Sales) \* 365 – indicates collection of sales on credit, lower the number the quicker funds are collected
- Accounts Payable Days = (Accounts Payable / COGS) \* 365 – indicates how quickly you are paying for purchases - if this is too low, you are basically paying cash or COD for everything, too high may mean vendors will not deliver your goods
- Interest Coverage Ratio = Earnings Before Interest Tax Depreciation and Amortization (EBIDTA) / Interest Expense

# ONGOING REPORTING REQUIREMENTS

## Other Key Ratio Formulas (Continued)

Return on Equity = Net Income / Total Equity

Return on Assets = Net Income / Total Assets

Fixed Asset Turnover = Sales / Gross Fixed Assets

Sales per Employee = Sales / Total Employees (FTE)

Profit per Employee = Adjusted Net Profit Before Taxes / Total Employees (FTE)

Profit Growth = (Current Period Adjusted Net Profit Before Taxes - Prior Period Adjusted Net Profit Before Taxes) / Prior Period Adjusted Net Profit Before Taxes

Sales Growth = (Current Period Sales - Prior Period Sales) / Prior Period Sales

# ONGOING REPORTING REQUIREMENTS



- **Industry:**
- 4237 - Hardware, and Plumbing and Heating Equipment and Supplies Merchant Wholesalers
- **Sales Range:**All Sales Ranges
- **Data Source:**Private Companies
- **Location:**All Areas

## Average by Year (Number of Financial Statements)

Financial Metric	Recent 12 Months (216)	2010 (259)	2009 (379)	All Years (3465)
Current Ratio	2.73	2.66	2.87	2.71
Quick Ratio	1.33	1.33	1.40	1.39
Gross Profit Margin	31.55%	31.99%	31.11%	31.40%
Net Profit Margin	2.91%	2.77%	2.00%	3.76%
Inventory Days	73.80	71.08	70.31	66.96
Accounts Receivable Days	44.11	45.28	40.94	42.09
Accounts Payable Days	42.35	43.34	37.05	38.32
Interest Coverage Ratio	7.52	7.26	5.16	7.31
Debt-to-Equity Ratio	2.29	2.11	2.25	2.08
Debt Service Coverage Ratio	2.65	2.40	2.19	2.53
Return on Equity	9.58%	8.75%	7.64%	13.66%
Return on Assets	5.99%	5.30%	4.63%	6.97%
Fixed Asset Turnover	12.13	11.42	12.34	14.42
Sales per Employee	\$374,331	\$386,232	\$354,251	\$330,179
Profit per Employee	\$14,576	\$14,727	\$10,965	\$13,405

Growth Metric	Recent 12 Months (104)	2010 (116)	2009 (170)	All Years (1560)
Sales Growth	3.69%	1.37%	-9.42%	4.37%
Profit Growth	6.93%	10.64%	-17.06%	9.31%

(2)

- The bank will use their own source for industry comparisons

# TYPES OF LOANS

- Line of Credit

- Secured – usually by inventory or receivables
- Unsecured – rare, usually for low value sometimes used as a “patch” until information is provided for line renewal or for company with very high net worth
- Revolving - does not require 30 day pay down during the year and is usually reviewed for annual renewal
- May require certain loan covenants
- May require personal guarantee

# TYPES OF LOANS

- **Line of Credit (Continued)**
  - Line of credit based on asset borrowing base
    - Usually up to 50% of raw material and finished goods inventory
    - Usually up to 75% of “qualified” receivables (not past due or uncollectible)
    - Require periodic borrowing base certificate reporting to the bank, monthly or sometimes weekly ( provides calculation of the maximum amount that can be borrowed)
    - Bank may send auditors to audit the information provided

- **Equipment Loans**
  - Terms may vary 3 – 7 years
  - Secured by the equipment and usually all the covenants will be the same as your line of credit
  - Review cash flow for interest and principal payments ( for example: bank may be able to structure interest only payments for a contractor during the winter months, or interest only until installation of equipment when an upfront deposit is required)
  - Review possible prepayment penalties and documentation fees

# WHAT TO DO IF YOU NEED MORE FINANCING

# WHAT TO DO IF YOU NEED MORE MONEY

- Remember the banker is part of your team with your certified public accountant and attorney - keep the lines of communication open
- Make sure you are making your current loan payments timely
- Assess what collateral is available for the new loan or increase in the line of credit
- You will need to provide current internal financial information

# WHAT TO DO IF YOU NEED MORE MONEY

- Update your financial projections
  - Make sure they are realistic - identify your significant assumptions
  - If new equipment involved, allow time for purchase, installation and training of new employees
  - Build in your actual cash flow (from material purchase or wages paid through collection of accounts receivable)
  - Document any new contracts from both customers and vendors
- Your certified public accountant can help review and challenge these projections, but ultimately you know your industry and you need to understand these items to successfully run your business.
- Always remember to use your team of advisors.

# RESOURCES

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- <http://www.360financialliteracy.org/Topics/Owning-a-Business/Business-Planning-Basics>  
AICPA website for business and personal financial literacy
- <http://www.profitcents.com/>  
Sage Profit Cents Software

# QUESTIONS



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