SBA Helps Small Businesses Think Big

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Corporate icons such as Nike, FedEx, and Apple Computer all started small. The Small Business Administration (SBA) helped start and finance these well-known business leaders and others, such as A&W Brands Holding Co., Outback Steakhouse, Staples, AOL, Intel, Hewlett-Packard, and Callaway Golf Company. So what is a small business? According to the Small Business Act, a small business is "one which is independently owned and operated and which is not dominant in its field of operations." Of course, the mom and pop shops fall within this definition. But much larger businesses are considered small under these criteria and include about 99.7% of all U.S. businesses, making up about 27 million small firms and farms.

Founded in 1953 to aid small businesses, the SBA provides programs that include financial, procurement, and management assistance and special outreach programs to minorities and armed forces veterans. The SBA has helped nearly 20 million small firms, making it the government's most cost-effective instrument for economic growth.

The SBA currently has four main financial assistance programs. We'll discuss the programs, how to apply, and eligibility and feasibility criteria. We hope this article will be a handy management counseling tool for the accountant who serves small businesses.

SBA BUSINESS LOAN PROGRAMS

The local commercial bank is a common source of funds to finance small businesses. If the credit risk of an owner-manager exceeds the level a local banker desires, the lender may apply to the SBA for an SBA-guaranteed loan. Other sources of capital may include individuals, other banks, credit unions, commercial finance companies, venture capital firms, local certified development companies (CDCs), life insurance companies, small business investment companies (SBICs), supplier financing, advance payments from customers, leasing companies, and factoring houses. Renting may be a wise choice at the start of a business venture because it requires less loan funds at the beginning.

Since most businesses are eligible for SBA financial assistance, the SBA is one of the best sources of financial assistance for small firms. Its philosophy is to leverage SBA resources by using commercial banks and resource partners to make loans, provide management assistance, and provide procurement assistance. The four main business loan programs are:

1. The 7(a) Loan Guaranty Program (the SBA's primary financial assistance program),
2. SBA 7(M) Microloan Program,
3. SBA Section 504 Loan Program, and
4. The Small Business Investment Company (SBIC) Program.

Let's take a look at each.

The 7(a) Loan Guaranty Program

The SBA designs programs under the 7(a) Program for special purposes. These loan programs include the 7(a) Loan Guaranty Program, SBA LowDoc Program, CAPLines Program, SBA Express, Pollution Control Loans, the International Trade Loan Program, and others.

The SBA may guarantee up to 85% on loans less than $150,000. Loans greater than $150,000 may receive a maximum guaranty of 75%, and, in most cases, the loan can't exceed $1 million. SBA's maximum loan amount is $2 million. Since the bank makes the loan with the SBA guaranteeing it, the bank can sell the guaranteed portion to a secondary market, providing the bank with liquidity and, at the same time, profitability from the new customer base. SBA-guaranteed loans usually have longer terms than conventional ones. The maximum term is 25 years for fixed-asset loans, and working capital loans are usually limited to 10 years.

Both fixed and variable interest rates are available. The interest rates on SBA-guaranteed loans may be lower than conventional bank loans for comparable risks. Pegged to the New York prime as published in *The Wall Street Journal*, interest rates are usually a couple of percentage points above prime and may range above the prime rate from 2.25% for loans less than seven years to 2.75% for loans seven years and over. Higher rates may apply to loans under $50,000. SBA charges the lender a one-time guaranty fee of 2.5% to 3.5%, depending on the loan size, which the lender may then pass on to the borrower.

Companies may use SBA-guaranteed loans for most legitimate business purposes, such as expanding, renovating, or purchasing a business; purchasing machinery, fixtures, and leasehold improvements; financing accounts receivables and augmenting working capital; refinancing existing debt; constructing commercial buildings; and purchasing land and/or buildings.

The SBA 7(M) Microloan Program

Small firms that need smaller amounts of money for financial and technical assistance to start or expand the business can receive Microloans. Limited to $35,000 for short-term loans, the average is about $13,000 and has terms of six years or less. Interest rates vary depending upon the lenders, and lenders generally require the borrower's personal guarantee.

How does the Microloan Program work? The SBA first loans funds directly to nonprofit community-based lending organizations (called intermediaries) that pool the money with local funds. Your local SBA office has lists of the nearest nonprofit intermediary lenders. The small business applies directly to the nonprofit intermediary for the loan, and the intermediary provides technical assistance to Microloan borrowers. These loans, which are *not* for paying off existing debt, are for buying machinery and equipment, furniture and fixtures, inventory, supplies, and working capital.

SBA Section 504 Loan Program

Often referred to as the Certified Development Companies (CDCs) Program, the SBA Section 504 Loan Program funds long-term financing of fixed assets at a fixed rate of interest. SBA CDC loans are made through SBA-certified local development companies. The majority of loans are made to *existing businesses*, but new businesses may receive loans to buy real estate and equipment. About 270 CDCs operate nationwide, each covering a specific geographic area.

Aimed at both increasing employment and aiding the local community, the typical 504 Loan Program projects are large and range in size from $500,000 to $2 million, with an average cost of $1 million. Participants in CDC projects include banks, professional organizations, community groups, investors, and utilities.

Typically, the 504 Loan Program shares the financing among the bank, CDC, and owner-manager to finance the small firm's fixed assets. A commercial lender makes the loan at its rates for 50% of the small business project, taking a first-lien position on all collateral. The CDC makes a loan covering 40% of the cost, which is backed by a 100% SBA-guaranteed debenture. At least 10% of the cost must come from the small business. The maximum SBA-guaranteed debenture guarantee may not exceed $1.5 million for job creation and community development. Although the SBA participation is limited, the projects may be unlimited in size because of local participation.

The terms, interest rate, and fees charged for the 504 loans are different from the regular 7(a) Program and Microloan Program. Interest rates are pegged to an increment above the current market rate the U.S. Treasury issues. Maturities of 10 and 20 years are available, and fees are about 3% of the debenture and may be financed with the loan. Collateral is usually made up of the project assets being financed. This loan requires personal guaranties of the principal owners.

Eligible businesses must be operated for profit and follow SBA size standards for small businesses. The general 504 guidelines are that a business qualifies as small if it doesn't have a tangible net worth in excess of $6 million, including affiliates, and doesn't have an average net income in excess of $2 million after taxes for the preceding two years. Loans may not be made for speculation or investments in rental real estate.

Small Business Investment Company (SBIC) Program

The SBIC Program was created in 1958 to fill the need for venture capital and needs of small firms in start-up and growth situations. It assists SBA-licensed business investment companies, which, in turn, provide equity capital, make long-term loans, and supply advisory services to small firms. Privately owned and managed investment firms, SBICs use their own capital, plus funds borrowed with an SBA guarantee, to make venture capital investments. All SBICs are profit-motivated businesses.

SBIC loans to small firms are for long-term periods to provide sound financing and growth potential. Loan terms are limited to 20 years, but loans and debts purchased as securities from small firms should have a minimum term of five years. SBICs must provide equity capital to small firms and may do so by purchasing the equity securities. A corporation, limited partnership, or limited liability company may apply to the SBA for an SBIC license.

APPLYING FOR A LOAN

Before seeking a loan through the SBA, the prospective borrower must first apply to local banks for a conventional loan. Prospective borrowers should do their homework before approaching the bank. If the bank would like to make the loan but risk factors exist beyond those allowed under bank policy, the bank may contact the SBA. Only qualified banks, those having guarantee agreements with the SBA, are eligible to participate in the guaranteed loan programs. The borrowers work with the local banker, and the bank deals directly with the SBA.

The prospective borrower should begin the loan proposal with a cover letter or executive summary. The cover letter should indicate the owner-manager(s)' background and nature of business. The loan proposal may have different formats depending on the commercial banker's requirements.

For a new business, the prospective borrower should prepare, in narrative style, the following information: type of business, products and services, brief history, proposed future operations, legal form of organization, location, customer base, competition, availability of suppliers, and any other details pertinent to the proposed business. A loan applicant starting a new business should take the following steps:

1. Prepare a résumé of owners and key people.
2. Prepare a personal balance sheet of fair values for all principal owners (20% or more) and guarantors. The financial statement shouldn't be older than 90 days.
3. Provide a pro-forma balance sheet for the proposed business that reflects sources and uses of both equity and borrowed funds.
4. Provide a projected income statement for at least one year or until positive cash flow is shown, including earnings and expenses. Explain the assumptions used for the estimates.
5. Attach a copy of the applicant's last year's federal income tax return.
6. Prepare an analysis of the capital requirements, including how much the borrower invests.
7. Provide a brief written statement indicating how the loan will be repaid, including repayment sources and time requirements. This brief statement should be supported by a cash forecast (budget) and other appropriate information to support the statement.
8. List collateral to be offered at fair market values. One

source of loan repayment is cash flow from a profitable business, and the second source is collateral pledged as assets to secure the loan.

9. Include other items that apply, such as leases, franchise agreement, purchase agreements, articles of incorporation, partnership agreement, copies of licenses, letters of reference, letters of intent, contracts, and plans.

For an established business, the borrower should include the same information as a new business, as well as the following:

◆ Provide business financial statements for at least the last three years, plus a current dated statement no older than 90 days, including balance sheets, income statements, and capital statements (reconciliation of net worth). In addition, include schedules for aging accounts receivables and payables and terms. Explain items of significance on the financial statement, and don't include personal items on these statements.

Note: The SBA requires the prospective borrower to sign a document allowing the agency to ask the IRS for tax returns.

ELIGIBILITY AND FEASIBILITY CRITERIA FOR LOANS

Both eligibility and feasibility criteria must be satisfied for loans made through SBA guaranties. First, a business owner-manager must meet eligibility criteria, such as the "credit elsewhere test" (meaning loan funds must not be available elsewhere on reasonable terms); then certain size standards must be met; and, last, the business must be in the public interest. Second, the loan must be feasible to make to the small firm with payment assured.

Eligibility Criteria

A small business must also conform to SBA guidelines as to number of employees and/or dollar volume (approximately 99.7% of all businesses qualify).

Generally, a small business is defined in 2008 as:

Manufacturers—Generally not more than 500 employees, but in some cases up to 1,500 employees.

Wholesalers—Not more than 100 employees.

Retail and service businesses—Average annual sales over three years or receipts of up to $6.5 million to $32.5 million, depending on business type.

Construction—Average annual sales or receipts over three years of up to $6.5 million to $31 million, depending on the specific business type.

Agricultural businesses—Annual receipts or sales of up to $500,000 to $9 million, depending upon type of organization.

Mining—Not more than 500 employees.

Other industries—Size standards vary by industry.

The size standards apply to all 7(a) Guaranty Loans and 504 Certified Development Company loan programs. The Microloan Program and SBIC Program have their own size standards. The disaster loan programs have their own eligibility standards. The SBA has further eligibility criteria based on the nature of the business and how the business will use the borrowed funds. For example, the business can't use the funds to encourage monopoly, speculation, gambling, or multilevel sales, and businesses primarily involved in rentals can't use the funds. Eligible small firms must also have a profit motive.

Feasibility Criteria

Clients can reduce the processing time for the loan considerably if they have done their homework with the intent of being well-prepared ahead of time. In analyzing the loan application, the loan officer will apply feasibility criteria that are similar to the credit criteria of a private lender. In order to determine if the loan will be repaid, the bank and SBA look at the **6 Cs of Credit** each time they make a loan:

Capacity is the ability of the borrower to repay the loan (cash flow).

Capital is the investment of the owner (equity and collateral).

Collateral is business and personal assets pledged. If the applicant has no collateral, he/she may obtain a personal guaranty from someone else to repay the loan.

Conditions relates to purpose of the loan, such as working capital or fixed assets, and to economic climate of the business (management ability and equity ratio).

Character is the personal impression the client makes on the banker (management ability).

Confidence is how the lender feels about the loan application, which is related to the other five Cs. The loan application should demonstrate professionalism, honesty, a good credit history, reasonable financial statements, and adequate collateral.

The SBA and bank may group the 6 Cs into four business areas to assess creditworthiness:

1. Cash Flow. A cash flow projection (forecast) demonstrates the loan can be repaid from earnings (demonstrates capacity).

2. Management Ability. The prospective borrower must show the ability to run the business (demonstrates character).

3. Equity. The prospective borrower should have his/her own capital at risk in the business. The debt-to-net worth ratio is important to demonstrate financial condition. New businesses should have a 2:1 or better ratio, with the borrower providing 33.33% or more of the assets, while established businesses should have a 4:1 or better ratio, with the borrower providing 20% or more of the assets. Nonbusiness assets pledged as collateral can't be part of equity (demonstrates capital and conditions). The SBA can't guarantee a loan to a business with a negative net worth.

4. Collateral. The type, value, and condition of collateral should be disclosed. The SBA won't refuse a loan on the sole grounds of inadequate collateral.

If the loan application shows that the loan is feasible, the client will generally obtain the necessary funds. The keys to successfully obtaining a loan are management ability and cash flow.

OBSERVATIONS

A loan application requires homework on the part of the prospective borrower to gather personal and financial facts. The accountant is a valuable adviser to put the loan package together. In addition to the minimum SBA loan package, the accountant and borrower may want to expand the information provided by developing a comprehensive business plan. The minimum SBA loan package may be enough to satisfy some bankers, but many bankers may want a more comprehensive business plan. The business plan should contain: principals involved, type and purpose of business, organizational plan, manufacturing plan, marketing plan, financial details, and supporting documents. Most bankers and investors ask for a good business plan, which helps borrowers and bankers determine the financial needs. The plan also serves as a guide during the lifetime of the business.

The business plan should be tailored to meet the needs of potential investors and creditors. The detail and length of the business plan depend on what the lender requires. Time is important in the business world, so the business plan should be a clear, concise report of future business operations, but it shouldn't require too much time to read and analyze. See the SBA homepage at www.sba.gov for detailed instructions on writing a winning business plan. To help companies prepare business plans, the SBA has resource partners, such as Small Business Development Centers (SBDCs), Service Core of Retired Executives (SCORE), Women's Business Centers, and Business Information Centers.

The SBA Answer Desk is open 24 hours, seven days a week, as a computerized telephone system to give assistance on financing and entrepreneurial development. The Answer Desk operators are available Monday to Friday from 9 a.m. to 5 p.m. Eastern time (call 1-800-U-ASK-SBA) (1-800-827-5722). Send e-mails to answerdesk@sba.gov.

KEEPING THE AMERICAN DREAM WITHIN REACH

Let's do a quick recap. Entrepreneurs must decide on alternative sources of financing. These may include private individuals, commercial banks, credit unions, SBA-guaranteed business loans, SBA Microloans, certified development company loans, small business investment companies' venture capital, or other channels.

The prospective borrower must do some homework before approaching the financial institution for a loan. While personal and financial information is needed to complete the basic loan package, a comprehensive business plan is often helpful, especially in asking for a large loan. Many smaller loans, however, have been made without a comprehensive business plan.

The bank loan officer will look at certain feasibility criteria to determine if the loan is workable. If the bank wants to make the loan but the inherent risks are higher than those allowed by bank policy, then the bank may contact the SBA. The bank and SBA both follow the same credit guidelines, often called the 6 Cs of Credit. After the new or existing business receives a loan, the SBA provides assistance through free and inexpensive management classes, consulting by retired executives, educational materials, and business opportunities through the government procurement programs.

Millions of companies have started, grown, and succeeded using SBA loans. The SBA helps small businesses think big and pursue the American dream. Financing is usually available if an owner-manager has a good idea and the management ability to make the business successful. ■

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For a copy of the SBA's Golden Anniversary Hall of Fame and a table on the SBA Guaranty Loan Programs, contact Henry Wichmann at ffhw@uaf.edu.