

Law Office Management & Technology

Make Your Banker Your Partner

By Paul Sullivan

Need a loan to grow your practice or even out cash flow? Here's what your banker has to offer and what you'll be asked to provide in return.

It's been said, "Bankers only loan money to those who don't need it." It's meant as a joke, but there's some truth to it. All business owners should consider having a line of credit in place before they ever need the money. This improves efficiency by making the funds available quickly when needed and allowing the approval process to be undertaken at a time convenient for everyone.

Financial institutions are highly regulated, so they take a hard look at any loan request. Although their main service is loaning money, they can only be profitable if they have reasonable assurance the loans will be repaid. For a small business, the qualification process can be time consuming and paperwork intensive. When you need funds quickly, the last thing you want to do is delay a business decision while waiting for a lengthy approval of the funds. Lenders offer different types of loans, and the qualification process can differ for each.

Types of loans

If you're a solo or practice in a small firm, you may never have had to finance expansion or take out a loan. Because this process of just asking for money can be intimidating, I thought it might be useful to explain what banks look for in loan requests and how different types of loans might work for your practice.

Line of credit. A line of credit is a commitment by the lender to have funds available on request up to a predetermined limit whenever the need arises. It is a short-term loan, usually for 12 months, which renews almost automatically as long as the borrower keeps the lender updated with certain financial information. Requests for funds are on demand, and principal repayments can be made as frequently or infrequently as the business climate dictates.

As a general rule, any interest accrued on the loans is paid monthly. The loan conditions often require a borrower to repay the principal in full at least once during the term period. Lines of credit are used primarily to level out cash flow. This type of loan could appeal particularly to a firm handling a personal injury case. The line of credit could fund the plaintiff's case expenses, and when the case is settled, the line could be paid off. Regular operating expenses would continue to be funded through regular cash flow. Required security will vary from business to business.

Term loan. Term loans are typically used to finance expansion. "Expansion" can mean anything from more equipment to more space to a new or additional location. The term loan allows the growth to occur without affecting your normal cash flow. Spreading out these costs allows you to absorb the expenditures over time instead of funding them through daily operations. As with a line of credit, the security required will vary depending on the financial strength of the business and its owners.

Equipment loan or lease. Some businesses will lease rather than buy new equipment because of the tax benefits. Purchased equipment may have to be capitalized and depreciated, while leased equipment may be classified as expense. The rules vary by business, so consult with your tax advisor before deciding whether to lease or buy equipment. The qualification process required by the lender or lessor is pretty much the same. Most equipment loans are secured by the lender taking a security interest in the equipment being purchased.

The application process can differ based on the relationship between the business and the lender. This is where the efficiency of having an established line of credit really pays off. If you have an established relationship with a line of credit and need to purchase additional equipment, you can sometimes do it with a simple telephone call. The lender knows you, knows your business, and generally just needs to gather minimal additional information.

If you do not have an established relationship with your banker, things are more complicated. Not only do you need to furnish lots of information, but the bank needs to verify it before granting final approval.

It gets even more complicated if you need expansion capital. The information they require will take a lot of time to gather, and then they must analyze it, analyze your business, and complete the approval process. If you have established your relationship beforehand with a line of credit, much of the paperwork is already in place.

What information does the bank need and what does it look for?

Lenders refer to the 3 C's of credit; character, capacity, and capital; as the foundation of all credit decisions. "Character" is your willingness to furnish information and your reputation (i.e., prior credit history). "Capacity" is your general ability to repay the debt. "Capital" is your specific ability to support the debt through secured or unsecured methods. About 90 percent of the lender's decision to loan is based on two numbers; your current cash flow and current net worth.

Lenders will compare your business to others in the same industry using financial ratios, which are excellent indicators for internal trending and can be used to compare your current performance to prior financial results. The ratio banks track most vigilantly is the debt/equity ratio. This reveals your business exposure to debt. It is arrived by dividing your total debt by the equity in your business. Usually a 3:1 ratio is the highest level acceptable, and they like to see a trend where it drops over time.

Lenders also track the working capital ratio (also known as current ratio) which is

derived by dividing current assets by current liabilities. This indicates a business' ability to pay short-term debts. The ideal is 2:1.

Management of accounts receivable is another area where bankers like to look, because they can gauge the quality of your clients and the efficiency of your billing and collection process by knowing the number of days in the average collection period. Anything under 45 days is considered very good, but the quality of the receivables falls off very quickly after 60 days, and in many cases bills are considered uncollectable after 90 days.

For sole practitioners, continuity of income is the major issue. The risk of a dried-up income stream is mitigated by life and disability insurance, which may or may not be assigned to protect the bank. Lenders might also inquire into your support staffing and backup or contingency plans in case of an illness or injury.

Since many sole practitioners are not incorporated, their personal tax returns provide most of the financial information required to determine cash flow for debt repayment. Lenders also analyze the balance sheet, income statement, and cash flow statement of the business itself to determine its viability. If the business is incorporated, the corporate tax return will provide most of the business information the bank needs, since it includes the income statement and balance sheet.

Certain types of practices have lending requirements that others do not. For example, lenders will probably analyze a personal injury lawyer's pipeline of cases to make sure they aren't "over loaning" probable settlements. Lenders might respond to requests for equipment or term loans by looking for projections of increased income to justify the added debt load.

Cultivate your relationship

Cultivate your banking relationship as you would cultivate a garden. You can't expect good long-term results without a little effort. Keep your banker informed even if you don't have an outstanding loan. Meet with him or her in person at least once or twice a year. A good relationship will maximize your chances of a long-term relationship, and beyond just lending you money and providing general business advice, your banker might be able to offer other useful services.

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