



Your Small Business Scorecard

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Being a successful entrepreneur takes a unique mix of skills and practices. You need to generate exciting ideas, deliver desirable products or services, maintain a winning attitude, set goals, undertake strategic planning and more, all while keeping an eye on the life's blood of your business -- its finances. To track your business's performance and plan effectively for future growth and opportunities, you must have a thorough understanding of how money flows through your business. You'll want to understand the important statements that reveal the company's financial position and how to measure the business's performance using accepted standards. This document offers you straightforward guidance to managing your company's financial information.

The Louisville Small Business Development Center is committed to providing educational resources that help entrepreneurs like you make the most of every busy, rewarding day. Small businesses are the heartbeat of this region's thriving economy, and we're here to help you succeed.



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When you own and operate a business, it's easy to become so involved in what's required from day to day that you overlook the need to keep an eye on the big picture. In order to succeed today, next month and next year, you must know how to assess whether your business is performing as it should be. The best way to do that is to keep an eye on your company's **scorecard**: your **financial statements**.

The numbers in your Balance Sheet and Income Statement let you calculate a variety of formulas and ratios that gauge your company's performance. Every business has strengths and weaknesses, and analyzing your financial statements will help you pinpoint them and see where you're doing well and where you need to improve. You can compare your business's scorecard to your scorecard from last year, to the average scorecards of other businesses in your industry, and to lending standards, which will allow you to assess your current position and plan for the future.

In this publication, you'll learn about these nine important financial metrics:

1. Working Capital
2. Current Ratio
3. Quick (or Acid Test) Ratio
4. Accounts Receivable Turnover
5. Inventory Turnover
6. Debt-to-Equity (or Leverage) Ratio
7. Accounts Payable Turnover
8. Debt Service Coverage (Cash Flow to Current Maturities) Ratio
9. Profit Margin (or Return on Sales)

Financial Statements Used to Build Your Business Scorecard

This section examines entries in your Balance Sheet and Income Statement that you can plug into nine calculations to create your business scorecard. These statements are discussed in detail in "Understanding Your Business's Financial Statements." Here's a reminder of what they're for:

- Your **Balance Sheet** tells you where your business stands at a particular point in time. As of today, or the end of the quarter, or the end of the year, how much does your business own (assets), how much does the business owe (liabilities) and what is the business's equity or net worth (capital)? The Balance Sheet is sometimes called a Statement of Financial Condition. (See the example on page 9.)
- Your **Income Statement**, on the other hand, defines your business's income, expenses, profit or loss, and loan interest during a defined period of time. The end product of these transactions is net income or loss. It may also be called a Statement of Profit and Loss (P&L), an Earnings Statement, an Operating Statement, or an Income and Expense Statement. (See the example on page 8.)

When you try the ratios and formulas presented in this section using your business's numbers and begin to make comparisons, be sure to use data from the same time period: the current quarter compared to the previous quarter, the current year compared to last year, and so on. Also keep in mind that your business's age, size and location, along with operational factors such as efficiency and managerial experience, may influence your scorecard results. Once you have a baseline scorecard and understand your business's performance relative to past performance and industry standards, you will be able to set your sights confidently on the future.

Liquidity

Your business's liquidity means how quickly or easily you can turn assets into cash if needed. Calculating your **1** Working Capital, **2** Current Ratio, and **3** Quick (or Acid Test) Ratio will tell you how liquid your company's assets are.

1 Working Capital

Where do you get the numbers?
From your Balance Sheet.

How do you calculate it?

$$A \text{ (Current Assets)} - B \text{ (Current Liabilities)} \\ = \text{Amt available in cash, inventory, and} \\ \text{Accounts Receivable}$$

For example...

$$\$157,000 - \$142,000 = \$15,000$$

What does it tell you?

Your business needs enough current assets to cover its current bills. The greater the amount of working capital you have on hand, the more cushion you have against short-term debt. In the example, the business has cash left over after paying its current bills.

2 Current Ratio

Where do you get the numbers?
From your Balance Sheet.

How do you calculate it?

$$\frac{A \text{ (Current Assets)}}{B \text{ (Current Liabilities)}}$$

For example...

$$\frac{\$157,000}{\$142,000} = 1.10$$

What does it tell you?

The Current Ratio measures whether your business has sufficient assets to pay its short-term debts using current assets. If this number is less than 1, the business doesn't have enough assets to pay all the bills that are due during the next 12 months. The greater the number, the better able you are to cover current debts that come due. Aim for a Current Ratio of 2 or more. The example business needs to increase its assets and/or decrease its liabilities.

3 Quick (or Acid Test) Ratio

Where do you get the numbers?
From your Balance Sheet.

How do you calculate it?

$$\frac{(A \text{ (Current Assets)} - C \text{ (Inventory)})}{B \text{ (Current Liabilities)}}$$

For example...

$$\frac{(\$157,000 - \$55,000)}{\$142,000} = .72$$

What does it tell you?

This metric is similar to the Current Ratio, but it removes inventory from the equation and instead uses only assets that are immediately available. It provides another measure of whether your business has sufficient assets to pay its short-term debts. If this number is less than 1, the business would have to sell off inventory in order to cover all of its short-term debts if they came due. Aim for a Quick Ratio of 1 or more. The example business needs to decrease its ending inventory and/or increase other assets.

Managing Assets

Your business's assets are the resources you have available to spend, grow and invest. Calculating your 4 Accounts Receivable Turnover and 5 Inventory Turnover will tell you how well you're managing your assets.

4 Accounts Receivable Turnover

Where do you get the numbers?
From your Balance Sheet and Income Statement.

How do you calculate it?

$$\frac{D \text{ (Accounts Receivable)}}{E \text{ (Net Sales)}} \times 365 \text{ days}$$

For example...

$$\frac{\$95,000}{\$876,000} \times 365 \text{ days} = 40 \text{ days}$$

What does it tell you?

This number tells you how many days it takes to collect money owed to your business. You should aim to make this number as low as possible; you should also compare it to your past turnover times and those of your industry. In the example, the business takes more than a month to collect its debts.

Note that the example uses the Accounts Receivable number from the Balance Sheet, which is a snapshot in time. This is fine if your receivables are fairly constant throughout each period or year. If they vary much, you may instead want to use an average Accounts Receivable number for the period.

5 Inventory Turnover

Where do you get the numbers?
From your Balance Sheet and Income Statement.

How do you calculate it?

$$\frac{C \text{ (Inventory)}}{F \text{ (Cost of Goods Sold)}} \times 365 \text{ days}$$

For example...

$$\frac{\$55,000}{\$589,000} \times 365 = 34 \text{ days}$$

What does it tell you?

This number tells you how many days it takes to sell (turn over) your business's inventory. You should aim to make this number as low as possible; you should also compare it to your past turnover times and those of your industry. Selling your inventory more quickly means less chance of excess items going bad or deteriorating, and higher sales. In the example, the business sells its inventory in a little over a month.

Note that the example uses the Inventory number from the Balance Sheet, which is a snapshot in time. This is fine if your inventory is fairly constant throughout each period or year. If it varies much, you may instead want to use an average inventory number for the period.

Managing Debt

How much have you invested in your business? How much do you owe lenders? The **6** Debt-to-Equity (or Leverage) Ratio and your **7** Accounts Payable Turnover will help you assess your debt.

6 Debt-to-Equity (or Leverage) Ratio

Where do you get the numbers?
From your Balance Sheet.

How do you calculate it?

$$\frac{G \text{ (Total Liabilities)}}{H \text{ (Total Equity)}}$$

For example...

$$\frac{\$176,000}{\$58,000} = 3$$

What does it tell you?

This ratio examines your business's leverage by determining the proportion of equity and debt that you're using to finance your operations. A high number means you're using a greater amount of debt and thus are paying more interest, which affects earnings. A lower number means a stronger equity position. This ratio is particularly sensitive to the industry you're in and whether it's capital intensive, but for small businesses a ratio of 2 or less is preferred. The example business should try to reduce its debt load.

7 Accounts Payable Turnover

Where do you get the numbers?
From your Balance Sheet and Income Statement.

How do you calculate it?

$$\frac{I \text{ (Accounts Payable)}}{J \text{ (Purchases)}} \times 365 \text{ days}$$

For example...

$$\frac{\$73,000}{\$504,000} \times 365 = 53 \text{ days}$$

What does it tell you?

By calculating this metric, you can determine the rate at which you pay off your business's suppliers. This is a measure of your liquidity; ideally, you should pay your bills in less than 30 days, and frequently suppliers offer discounts for doing so. The example business is taking nearly two months to pay its bills and may potentially be missing out on such savings.

Note that the example uses the Accounts Payable number from the Balance Sheet, which is a snapshot in time. This is fine if the time you take to pay bills is fairly constant throughout each period or year. If it varies much, you may instead want to use an average Accounts Payable number for the period.

Profitability

Of course you want to make a profit—that's why you're in business! The **8** Debt Service Coverage (Cash Flow to Current Maturities) Ratio and **9** Profit Margin (or Return on Sales) will tell you how profitable your company is.

8 Debt Service Coverage (Cash Flow to Current Maturities) Ratio

Where do you get the numbers?
From your Balance Sheet.

How do you calculate it?

$$\frac{K \text{ (Net Income)} + \text{Depreciation}}{L \text{ (Current Portion of Long Term Debt)}}$$

For example...

$$\frac{\$77,000}{\$3,000} = 26$$

What does it tell you?

This ratio compares your business's net income to your current debt service obligations (the annual portion of long-term debt) to determine how much cash flow you have available to cover your debts. This tells you whether you can readily pay your debts using cash flow rather than having to sell assets. A higher number means a company is less at risk of defaulting on current obligations. A number less than 1 indicates that a company can't pay its current debt service without dipping into assets and thus needs to consolidate debt or refinance. The example company doesn't have any depreciation, and it has plenty of cash flow to cover its current debt service.

9 Profit Margin (or Return on Sales)

Where do you get the numbers?
From your Income Statement.

How do you calculate it?

$$\frac{K \text{ (Net Income)}}{E \text{ (Net Sales)}} \times 100$$

For example...

$$\frac{\$77,000}{\$876,000} \times 100 = 8.8\%$$

What does it tell you?

This metric tells you how much net income your business is earning as a result of each dollar in sales. Obviously, the greater this number is, the better, in terms of your profitability! The example business is making an 8.8% profit on sales.

Income Statement

January 1- December 31

Sales		
Net Sales.....	876,000	← E
Cost of Goods Sold		
Beginning Inventory.....	43,000	
Purchases	504,000	← J
Labor (to produce goods)	97,000	
Less: Ending Inventory	(55,000)	
Total Cost of Goods Sold.....	589,000	← F
Gross Income (876 – 589)	287,000	
Expenses		
Selling Expenses.....	58,000	
General and Administrative	108,000	
Total Expenses	166,000	
Operating Income (287 – 166)	121,000	
Less: Interest Expense	(12,000)	
Net Income before Taxes	109,000	
Less: All Income Taxes	(32,000)	
Net Income	77,000	← K

Balance Sheet

Year End, as of Dec. 31

Assets		
Current Assets:		
Cash	7,000	← D
Accounts Receivable	95,000	← C
Inventory (ending)	55,000	← A
Total Current Assets	157,000	
Non-Current Assets:		
Fixed Assets	89,000	
Less Accumulated Depreciation.....	(16,000)	
Fixed Assets (net).....	73,000	
Advances to Owners	4,000	
Total Non-Current Assets	77,000	
Total Assets	234,000	
Liabilities		
Current Liabilities:		
Current Portion of Long-Term Debt	3,000	← L
Note Payable	64,000	
Accrued Taxes	2,000	
Accounts Payable	73,000	← I
Total Current Liabilities	142,000	← B
Long-Term Liabilities/Loan Payable	34,000	
Total Liabilities	176,000	← G
Owner's Equity		
Owner Investment.....	15,000	
Retained Earnings.....	43,000	
Total Equity	58,000	← H
Total Liabilities and Equity	234,000	

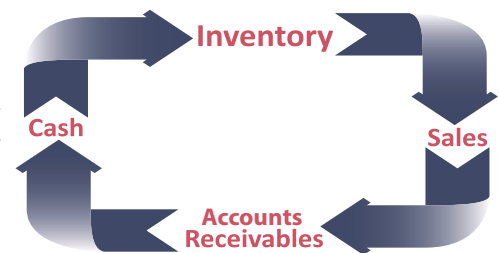
Scorecard

		Example Answer	OK?	Standard
Liquidity	① Working Capital	\$15,000	Yes	Positive Number
	② Current Ratio	1.1	Need to Increase	2 or greater
Managing Assets	③ Quick (or Acid Test) Ratio	.72	Need to Increase	1 or greater
	④ Accounts Receivable Turnover	40 days	Need to decrease	30 days
	⑤ Inventory Turnover	34 days	Yes	Depends on industry
Managing Debt	⑥ Debt-to-Equity (or Leverage) Ratio	3	Need to decrease	Depends on industry
	⑦ Accounts Payable Turnover	53 days	Need to decrease	30 days
Profitability	⑧ Debt Service Coverage (Cash Flow to Current Maturities) Ratio	26	Yes	2 or greater
	⑨ Profit Margin (or Return on Sales)	8.8%	Yes	Depends on industry

Your Scorecard and Your Operating Cycle

Your business's operating cycle is an ongoing process:

The faster your operating cycle, the more quickly you turn inventories into cash, the more quickly you can make or buy more inventory, and so on. Thus, a shorter cycle means your cash is more readily available, rather than being tied up in inventory. Several of the items on your Business Scorecard can help you assess your operating cycle:



- ④ Accounts Receivable Turnover—If you can speed up how quickly you collect your receivables, even by a few days, you can generate extra cash to fuel your operating cycle.
- ⑤ Inventory Turnover—A high number here means you have excess inventory. Cash is sitting on warehouse shelves instead of working for you! Reduce this number to get your operating cycle spinning.
- ⑦ Accounts Payable Turnover—When you take extra days to pay your bills, you may be effectively costing yourself more than necessary by missing out on discounts. Aim for a 30-day turnaround, and look for supplier discounts in return for paying more quickly. Then, put that extra cash to work!

Making Accurate Comparisons

As stated earlier, when you're calculating metrics for your company and comparing them to your results from other periods, be sure you use comparable data: the current quarter compared to the previous quarter, the current year compared to last year, and so on. When you do external comparisons, be sure you're looking at benchmarks and standards for your industry—these can vary widely, and you want to be sure you're comparing apples to apples.

The United States uses the North American Industry Classification System (NAICS) to track statistical information for businesses; this system categorizes businesses according to their production methods. You can determine your business's NAICS code by visiting www.census.gov/eos/www/naics/. Once you know your code, you can use it to compare your calculation results to those of other companies in your industry.

Where to Find More Information

- BizMiner is a subscription service that provides industry-average benchmarks for smaller businesses. See www.bizminer.com.
- Dunn & Bradstreet uses 14 financial ratios to measure a business's solvency, efficiency and profitability. See <https://www.dnb.com/product/contract/ratiosP.htm>.
- Mergent Online is a subscription service you can use to search for companies with the same NAICS code and generate comparison reports. See www.mergentonline.com.
- The Risk Management Association (RMA) publishes Annual Statement Studies containing comparative data from the financial statements of small and medium businesses. See www.rmahq.org/tools-publications/publications/annual-statement-studies.
- A wide range of information and resources is available via the Small Business Administration (SBA). See www.sba.gov.
- The Yahoo Industry Browser lets you examine many different performance rankings for a wide range of industries. See https://biz.yahoo.com/p/sum_conameu.html.



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