

**SAMPLE PAGES FROM**  
**FINANCIAL STATEMENT ANALYSIS**  
**UNDERSTANDING THE BUSINESS SCORECARD**

*A PRESENTATION FOR LENDERS BY*  
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This ratio is also called Total Liabilities to Net Worth. It shows the amount of external (borrowed) funds compared to the amount of internal (owner) funds.

Stated another way, it indicates the degree of dependence on creditors rather than owners.

A constant ratio of 2:1 is often considered a good use of leverage although this varies with the type of business.

**To Do**

Check the Year Before calculation below to be sure you understand the source of the numbers.

Calculate Last Year. Show the formula as well as the answer.

Check page 4-9 for the industry average from the Prentice Hall table.

Formula:	Last Year	Year Before	Industry
$\frac{\text{Total Liabilities (Debt)}}{\text{Net Worth (Capital or Equity)}}$		$\frac{146}{132}$	
Debt to Equity>>>>		1.11:1	

**WHAT DOES IT MEAN?**

"Last year, for every dollar of \_\_\_\_\_ the company had \_\_\_\_\_ of \_\_\_\_\_."

STILL ANOTHER WAY TO SAY THIS:

"For every dollar of \_\_\_\_\_ money, the company had \_\_\_\_\_ of \_\_\_\_\_ money."

**CIRCLE THE CORRECT RESPONSES**

Last year compared to the year before is:  
Higher Lower About the same

This trend is:

Positive Negative Depends  
(Consider if it was too high or lower than average to start with.)

Last year compared to industry averages:

Higher Lower About the same

Is this positive or negative?

Positive Negative Depends

**Too Low?**

A very low debt-to-equity ratio can indicate a business owner who is too conservative and foregoes good business opportunities because of fear of debt.

**Too High?**

Several possibilities...perhaps the borrower has been told 'yes' by lenders a

few times too many. Or the owners have been withdrawing capital out of the business.

Before you get too concerned, consider a pattern I often see in the smaller businesses. The company makes money and the owner takes it home...regardless of adequate capitalization of the business.

When you look at the owner's financials, you may find there are plenty of liquid assets and the owner may stand ready to reinvest the capital if need be.

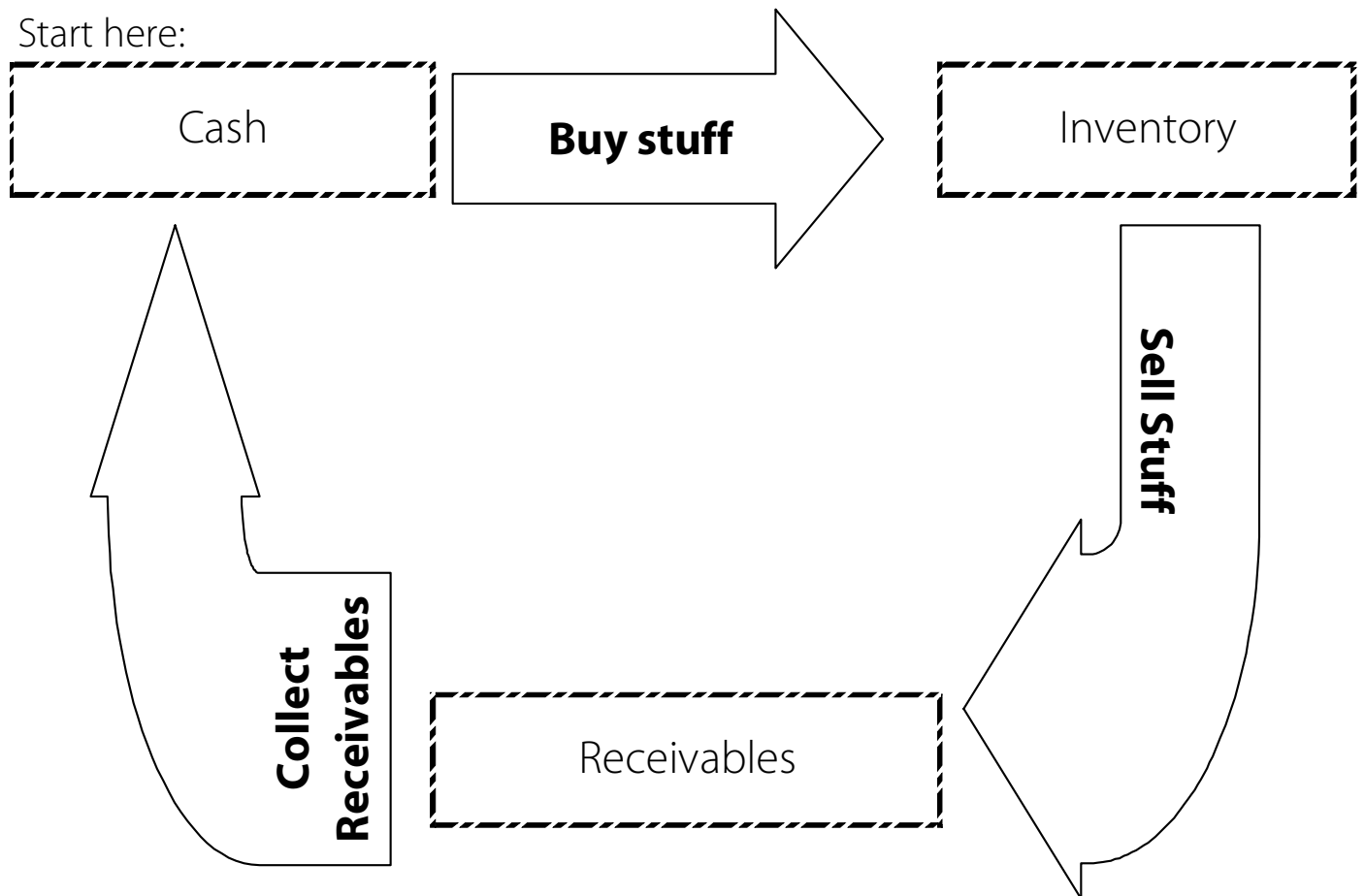
With smaller businesses you often have to look at the big picture.

**HOW MUCH MORE CAN THEY HANDLE?**

To calculate the additional debt the company could carry, multiply the acceptable debt to equity ratio (from industry standards or your internal guidelines) times end of year equity (capital).

Compare your answer to the end of year debt (total liabilities) to see if there is room to lend more...and how much.

Better yet, use the most recent financial statement you can obtain. Remember a lot may have happened since the previous year end.

**OPERATING CYCLE****OPERATING CYCLE**

Generally, the more times in a year the business can go through its cycle the more profitable it can be.

The business owner/manager wants to optimize the time goods are held in inventory and the time it takes to collect the receivables.

**HOW SHORT CAN IT BE?**

For purposes of profitability, it might seem that the very shortest cycle would be the best.

However, if the owner keeps inventory too low, he'll be out of stock when the customer wants to buy and may lose sales.

If the owner doesn't offer as liberal credit terms as his competitor, he may

lose market share.

It is a matter of balance.

On the next few pages, we'll learn how to measure the two components of the operating cycle: Days in Inventory and Days in Receivables.