THE SMALL BUSINESS REPORT CARD

Is Your Business Making the Grade?

This number-crunching study guide has the answer.

Tennessee Small Business Development Center Network Lead Center
Middle Tennessee State University, PO Box 98, Murfreesboro, TN 37132
Toll Free: 877-898-3900 Phone: 615-849-9999 Fax: 615-893-7089
Greetings:

Middle Tennessee State University’s Tennessee Small Business Development Center (TSBDC) program is the premier provider in Tennessee of business technical assistance and training. Our business development services are provided through a network of 20 locations across the state all in an effort to enhance economic development for our state while growing our small businesses.

This publication is provided by the TSBDC for your use to enhance your understanding of the subject matter and thereby increasing your business development opportunities. For further information regarding additional resources, our training calendar or to schedule an appointment with a business counselor, go to www.tsbdc.org

Regards,

Patrick R. Geho, J.D.
State Executive Director
Tennessee Small Business Development Centers
Professor – Department of Management
Jennings A. Jones College of Business
If you own a business, you know how much hard work and dedication it requires. Sometimes your energy is so focused on day-to-day operations that you forget to step back, look at the big picture and gain valuable perspective.

How can you tell if your business is performing well? By using numbers from your company’s financial statements, you can calculate ratios and formulas that grade the performance of your business. This report card reveals the strengths and weaknesses of your company – and provides an opportunity for solid improvement.

By comparing your grades to industry averages, acceptable lending ranges and prior years’ performances, you will begin to develop “big picture vision.” Remember, these are averages of the health of your business, so expect your current grades to fall above or below them. Factors that can create differences include the company’s age, the number of locations, the expertise of managers and the efficiency of operations.

This book will walk you through the two financial statements that are used to calculate ratios and formulas – the Balance Sheet and the Income Statement. These two statements will help provide a clear understanding of your business health, but remember that they need to compare the same time periods (this year vs. last year, this quarter vs. last quarter).

The Balance Sheet is one day in the life of a business, frozen in time. This statement shows what is owned (assets), what is owed (liabilities) and the net worth or equity of the business (capital).

The Income Statement is a moving picture that spans whatever length of time you determine. It displays both income and expenses, revealing the net profit or loss over a period of time. It also shows the interest you have paid on loans.

There are a handful of other names for the Income Statement, including Income and Expense Statement, Operating Statement, Earnings Statement and Profit and Loss Statement (P&L). No matter what it’s called, this statement will help you focus more clearly on your business’ performance.

The information in this book is designed to help you “score” some insight into the performance of your business.

This material is not intended to provide or take the place of legal or professional financial advice. If you need advice, look for a professional financial manager, consultant, accountant and/or attorney. Design: NewGround Publications. (Phone: 800 207-3550) Text: John Nelson & Karen Couto. All rights reserved. Photocopying any part of this book is against the law. This book may not be reproduced in any form, including xerography, or by any electronic or mechanical means, including information storage and retrieval systems, without prior permission in writing from the publisher.
In a business, assets are like fuel. But how effectively are you managing them? Formulas 1 & 2 have the answer.

### Accounts Receivable Turnover

**Formula**

\[
\text{Accounts Receivable Turnover} = \frac{\text{Net Sales}}{\text{Average Receivables}}
\]

- **What It Shows**: How many days it takes to collect money owed to you. A lower answer is better.
- **The Number Source**: Balance Sheet and Income Statement
- **The Goal**: To reduce turnover time
- **The Plan**: Right now, the Accounts Receivables turnover is $75,000/30 days, or $2,250 per day.

If Accounts Receivable are collected just four days faster, (in 26 days instead of 30), the result is $9,000 in extra cash (4 days x $2,250).

### Inventory Turnover

**Formula**

\[
\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}
\]

- **What It Shows**: How many days it takes to turn over (or sell) your inventory. A lower answer is better.
- **The Number Source**: Balance Sheet and Income Statement
- **The Goal**: To reduce excess inventory
- **The Plan**: Inventory now turns every 57 days, equaling $1,491 per day. (Ending inventory of $85K divided by 57 days)

If inventory is re-stocked every 30 days instead of 57, you cut 27 days from the formula. At $1,491 per day, the result is a $40,257 savings in inventory expenses.

### Balance Sheet

**Year End/As of Dec. 31**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets:</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>75,000</td>
</tr>
<tr>
<td>Inventory (ending)</td>
<td>85,000</td>
</tr>
<tr>
<td>Total Current Assets</td>
<td>170,000</td>
</tr>
<tr>
<td>Non-Current Assets</td>
<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>140,000</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>(25,000)</td>
</tr>
<tr>
<td>Fixed Assets (net)</td>
<td>115,000</td>
</tr>
<tr>
<td>Advances to Owners</td>
<td>6,000</td>
</tr>
<tr>
<td>Total Non-Current Assets</td>
<td>121,000</td>
</tr>
<tr>
<td>Total Assets (170+121)</td>
<td>291,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities</td>
<td></td>
</tr>
<tr>
<td>Current Portion of Long-Term Debt</td>
<td>6,000</td>
</tr>
<tr>
<td>Note Payable</td>
<td>100,000</td>
</tr>
<tr>
<td>Accrued Taxes</td>
<td>3,000</td>
</tr>
<tr>
<td>Accounts Payable (A/P)</td>
<td>41,000</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td>150,000</td>
</tr>
<tr>
<td>Long-Term Liabilities/Ln Payable</td>
<td>54,000</td>
</tr>
<tr>
<td>Total Liabilities (150+54)</td>
<td>204,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital or net worth</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Owners Investment</td>
<td>20,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>67,000</td>
</tr>
<tr>
<td>Total Capital</td>
<td>87,000</td>
</tr>
<tr>
<td>Total Liabilities &amp; Capital (204+87)</td>
<td>291,000</td>
</tr>
</tbody>
</table>

### Income Statement

**January 1- December 31**

<table>
<thead>
<tr>
<th>Sales</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>900,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cost of Goods Sold:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Inventory</td>
<td>75,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>350,000</td>
</tr>
<tr>
<td>Labor</td>
<td>200,000</td>
</tr>
<tr>
<td>Total</td>
<td>625,000</td>
</tr>
<tr>
<td>Less: Ending Inventory</td>
<td>(85,000)</td>
</tr>
</tbody>
</table>

| Gross Profit (900 less 540) | 360,000 |

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Expenses:</td>
<td></td>
</tr>
<tr>
<td>- Selling Expenses</td>
<td>90,000</td>
</tr>
<tr>
<td>- General &amp; Administrative</td>
<td>170,000</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>260,000</td>
</tr>
<tr>
<td>Operating Income (360 less 260)</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>20,000</td>
</tr>
<tr>
<td>Profit</td>
<td></td>
</tr>
<tr>
<td>Net Profit before taxes (100 less 20)</td>
<td>80,000</td>
</tr>
<tr>
<td>Less: All Income Taxes</td>
<td>27,000</td>
</tr>
<tr>
<td>Net Profit (80 less 27)</td>
<td>53,000</td>
</tr>
</tbody>
</table>
Liquidity indicators show a company’s ability to turn an asset into cash. How “cash rich” is your company? Formulas 3, 4 and 5 have the answer.

### 3 Working Capital

**FORMULA**

\[
\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{170,000}{150,000} = 1.13
\]

**What It Shows**

Whether a company has enough current assets to operate the business on a daily basis, and to pay its current bills. **Higher numbers are better.**

**The Number Source**

Balance Sheet

**The Goal**

To keep enough money on hand for daily operations. The answer must be positive. If the answer is negative, more money is needed to meet expenses.

**The Plan**

By following the tips below, working capital is preserved. Note: This business has an excess amount after paying all current liabilities.

### 4 Quick or Acid Test Ratio

**FORMULA**

\[
\frac{\text{Total Current Assets} - \text{Inventory}}{\text{Total Current Liabilities}} = \frac{170,000 - 85,000}{150,000} = .56
\]

**What It Shows**

If inventory should become obsolete, this ratio eliminates it from current assets and cash. The ratio is called “quick” because it includes items that can be turned into cash quickly.

**The Number Source**

Balance Sheet

**The Goal**

The answer should be 1 or higher.

**The Plan**

By following the tips below, inventory is managed properly.

### 5 Current Ratio

**FORMULA**

\[
\frac{\text{Total Current Assets}}{\text{Total Current Liabilities}} = \frac{170,000}{150,000} = 1.13
\]

**What It Shows**

This ratio reveals a company’s ability to pay short-term debt. **A higher number is better.**

**The Number Source**

Balance Sheet

**The Goal**

The answer should be 2 or more, meaning the company has twice as many assets as liabilities. This example means there is $1.13 available in cash and current assets to pay every $1 of current liabilities.

**The Plan**

Take advantage of the tips below.

### Tips for Improving Your Score for Formulas 3, 4 and 5

- Collect Accounts Receivable quicker with a better credit policy (see Formula 1 on page 4)
- Decrease inventory turnover (see Formula 4 on page 4)
- Pay Accounts Payable faster and take advantage of trade discounts (see Formula 7 on page 6)
- Increase profit margins by raising prices and selling more products/services (see Formula 9 on page 7)
DEBT MANAGEMENT

6 Leverage or Debt-to-Worth Ratio

Formula

\[
\frac{\text{Total Liabilities}}{\text{Total Capital}} = \frac{204,000}{87,000} = 2.34
\]

What It Shows ▶ Whether a company has enough equity.

The Number Source ▶ Balance Sheet

The Goal ▶ An answer of 3 or lower is preferred. This company is leveraged 2.34 times, meaning for every $1 owners have invested, lenders and creditors have invested $2.34.

The Plan ▶ Decrease leverage by increasing the amount of money earned and kept in retained earnings.

7 Accounts Payable Turnover

Formula

\[
\frac{\text{Accounts Payable at } 41,000 \times 365 \text{ days}}{\text{Purchases}} = \frac{14,965,000}{350,000} = 42.75
\]

What It Shows ▶ How quickly a business pays its suppliers.

The Number Source ▶ Balance Sheet and Income Statement

The Goal ▶ To pay bills faster. Lower numbers (30 days or less) are better. This business now takes 43 days to pay its suppliers.

The Plan ▶ Take advantage of discounts that often apply if a bill is paid early. “2%, 10 days, net 30 days” means 2% may be deducted from an invoice if it’s paid in 10 days. For example, if the $350,000 in annual purchases was paid in 10 days, the savings would be $7,000 yearly.

BALANCE SHEET Year End/As of Dec. 31

Assets
Current Assets:
- Cash ......................... 10,000
- Accounts Receivable ........ 75,000
- Inventory (ending) ............. 85,000
Non-Current Assets:
- Fixed Assets ................. 140,000
- Less Accumulated Depreciation .... (25,000)
Total Non-Current Assets ........ 121,000
Total Assets (170+121) ........ 291,000

Liabilities
Current Liabilities:
- Current Portion of Long-Term Debt .... 6,000
- Note Payable .................. 100,000
- Accrued Taxes .................. 3,000
- Accounts Payable (A/P) ............ 41,000
Total Current Liabilities ........ 150,000
Long-Term Liabilities/Loan Payable ... 54,000
Total Liabilities (150+54) ........ 204,000

Capital or net worth
- Owners Investment .............. 20,000
- Retained Earnings .............. 67,000
Total Capital .................... 87,000
Total Liabilities & Capital (204+87) ........ 291,000

INCOME STATEMENT January 1- December 31

Sales
Net Sales ......................... 900,000

Cost of Goods Sold:
- Beginning Inventory ............ 75,000
- Purchases ...................... 350,000
- Labor .......................... 200,000
Total Cost of Goods Sold ........ 625,000
Less: Ending Inventory .......... (85,000)
Cost of Goods Sold (625 less 85) .... 540,000
Gross Profit (900 less 540) ......... 360,000

Expenses
Operating Expenses:
- Selling Expenses ............. 90,000
- General & Administrative .... 170,000
Total Expenses ................ 260,000
Operating Income (360 less 260) ...... 100,000
Interest Expense ................ 20,000

Net Profit before taxes (100 less 20) ........ 80,000
Less: All Income Taxes .......... 27,000
Net Profit (80 less 27) .............. 53,000

Investing in a business is serious business. To find out how much money owners have invested versus lenders, plug your numbers into Formulas 6 and 7.
No matter what kind of product or service you provide, turning a profit is the goal. So how are you doing? Formulas 8 and 9 give you the bottom line.

**8 Cash Flow to Current Maturities or Debt Service Ratio**

**FORMULA**
Net profit of $53,000 plus $13,000 in depreciation
\[
\frac{\$66,000 - \$6,000}{\text{Current Portion of Long Term Debt}} = \frac{\$60,000}{\$11}\text{ for every dollar of payments $11 is available to pay it}
\]

**What It Shows**  Your ability to pay term debts after owner withdrawals.

**The Number Source**  Balance Sheet and Income Statement

**The Goal**  An answer of 2 or more is preferred. New businesses use one year’s worth of loan payments instead of the Accounts Receivable figure.

**The Plan**  To increase debt service, do three things: 1) refinance at a lower rate, 2) ask if you can pay interest only on loans for a period of time, and 3) consolidate debt in order to pay it back over a longer period of time.

Due over the next year or $150 per month

**9 Profit Margin on Sales**

**FORMULA**
Net Profit
\[
\frac{\$53,000 - \$900,000}{\text{Net Sales}} = 0.0588\text{ 5.9% profit margin when converted to a percentage}
\]

**What It Shows**  The percentage of net profit for every dollar of sales.

**The Number Source**  Income Statement

**The Goal**  The higher the number, the better.

**The Plan**  To increase your profit margin, follow three courses of action: raise prices, lower the cost of goods and reduce expenses.

---

**INCOME STATEMENT** January 1- December 31

<table>
<thead>
<tr>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
</tr>
</tbody>
</table>

**Cost of Goods Sold:**
- Beginning Inventory: \( \underline{75,000} \)
- Purchases: \( \underline{350,000} \)
- Labor: \( \underline{100,000} \)

Total: \( \underline{625,000} \)
Less: Ending Inventory: \( \underline{(85,000)} \)
Cost of Goods Sold (625 less 85): \( \underline{540,000} \)
Gross Profit (900 less 540): \( \underline{360,000} \)

**Expenses**
- Operating Expenses:
  - Selling Expenses: \( \underline{90,000} \)
  - General & Administrative: \( \underline{170,000} \)

Total Expenses: \( \underline{260,000} \)
Operating Income (360 less 260): \( \underline{100,000} \)
Interest Expense: \( \underline{20,000} \)

**Profit**
- Net Profit before taxes (100 less 20): \( \underline{80,000} \)
- Less: All Income Taxes: \( \underline{27,000} \)
- Net Profit (80 less 27): \( \underline{53,000} \)

Loan to be paid back over time. $60K loan with $54K due over time and $6K due in one year - Current Portion of Long-Term debt
# REPORT CARD

<table>
<thead>
<tr>
<th></th>
<th>PAGE</th>
<th>BOOK ANSWER</th>
<th>COMMENT</th>
<th>STANDARD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Accounts Receivable Turnover</td>
<td>4</td>
<td>30.4 days</td>
<td>Good</td>
<td>30 days</td>
</tr>
<tr>
<td>2. Inventory Turnover</td>
<td>4</td>
<td>57.4 turns</td>
<td>Good</td>
<td>Match Industry</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Working Capital</td>
<td>5</td>
<td>$20,000</td>
<td>Good</td>
<td>Positive Number</td>
</tr>
<tr>
<td>4. Quick or Acid Test</td>
<td>5</td>
<td>.56</td>
<td>Increase</td>
<td>1 or more</td>
</tr>
<tr>
<td>5. Current</td>
<td>5</td>
<td>1.13</td>
<td>Increase</td>
<td>2 or more</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Leverage (or Debt-to-Worth)</td>
<td>6</td>
<td>2.34 times</td>
<td>Good</td>
<td>3 or less</td>
</tr>
<tr>
<td>7. Accounts Payable Turnover</td>
<td>6</td>
<td>42.75 days</td>
<td>Decrease</td>
<td>30 days</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Cash Flow to Current Maturities (Debt Service)</td>
<td>7</td>
<td>$11</td>
<td>Good</td>
<td>2 or more</td>
</tr>
<tr>
<td>9. Profit Margin on Sales</td>
<td>7</td>
<td>5.9%</td>
<td>Good</td>
<td>Match Industry</td>
</tr>
</tbody>
</table>

## Compared To What?

How Industry Standards Can Lend Valuable Perspective

Knowing what the average grades are for your industry really gives you a barometer for assessing the performance of your own company. Use your business’ North American Industry Classification System (NAICS) code number to compare your grades to industry standards. Find your number at [www.sba.gov/businessop/standards/naics.html](http://www.sba.gov/businessop/standards/naics.html)

### Industry Resources

Check your library or the Internet for these resources:

- Small Business Administration/SBA
- Risk Management Association Annual Statement Studies
- Dun & Bradstreet’s Key Business Ratios
- Prentice Hall’s Almanac of Business and Industry Ratios
- Your local, regional and national trade associations

---

**WHAT MAKES A BUSINESS GO ROUND?**

EVERY SUCCESSFUL BUSINESS PUTS A SPIN ON MAKING THE OPERATING CYCLE TURN FASTER. THE FASTER THE CYCLE, THE BETTER YOUR BUSINESS’ GRADES AND THE MORE MONEY YOU SAVE.

For example, the savings shown in these three ratios total **$56,257**:

- **FORMULA 1** shows how collecting Accounts Receivable faster can produce $9,000 in extra cash. See page 4.
- **FORMULA 2** shows how restocking inventory every 30 days saves $40,257 in expenses. See page 4.
- **FORMULA 7** shows how paying bills faster results in a $7,000 savings. See page 6.
The TSBDC Network

Visit us at: www.tsbdc.org

Funded in part through a cooperative agreement with the U.S. Small Business Administration. Additional funding is provided by the Tennessee Board of Regents and State of Tennessee. All SBA programs are extended to the public on a nondiscriminatory basis. All opinions, conclusions, or recommendations expressed are those of the author(s) and do not necessarily reflect the views of the SBA and other program sponsors. All information is deemed reliable, but not guaranteed. All information, events, and/or prices are subject to change or withdrawal. The TSBDC Network shall not be held responsible for any typographical errors, misinformation, or misprints. Reasonable accommodations for persons with disabilities will be made if requested at least two weeks in advance. To inquire about accommodations or other questions contact your local service center via their contact information listed publically on the TSBDC website at https://www.tsbdc.org or the TSBDC Lead Center at 1-877-698-3900.