# THEME: BUSINESS RATIOS & BANK LOANS

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## ACCOUNTING TERM: Ratio

A ratio is a fixed relation between two similar things. It is simply one number, the base, divided into another number. Ratios may be expressed as percentages, as fractions, or as a stated comparison between two numbers. For example, you could describe the relationship of total revenue $150,000 and net profit of $52,500 as the following:

(1) Net profit is 35% of total revenue.
(2) Net profit is 1/ 2.86 or almost 1/3 of total revenue.
(3) The ratio of total revenue to net profit is 2.86 to 1.
(4) For every dollar of revenue the company earned 35 cents in net profit.

## FEATURE ARTICLE: Applying For A Business Loan: Putting Your Best Foot Forward.

Remember the book called “Catch 22”? It is now commonplace to call a “Damned if you do, and damned if you don’t” situation a “Catch 22”. This is a predicament that many small business owners have found themselves in. Running short of cash, the owner goes to the bank to borrow money, only to find that they don’t qualify for a loan because they don’t have enough money. This is quite maddening to the business owner who laments, “If I had enough money, I wouldn’t be asking for the blankety-blank loan!”

Seems kind of stupid, but you have to understand what bankers are up against. Number one, they have to have some assurance that they are going to be repaid. They have to sell this loan to the “loan committee” of the bank, and they are not about to present a package that will make them look foolish. Furthermore, they have auditors who look very closely to make sure the loans were issued according to bank policies and procedures. If a loan officer has too many loans that “go south”, then his/her track record starts to affect his/her career.

This is why you find many loan officers who go strictly “by the book”. These people refuse to look at any extenuating circumstances that might indicate that you would be a “good risk” regardless. Unless you fit into their narrow criteria of “risk” you might as well forget it.

It is best to find a bank manager or loan officer who has plenty of self-confidence, is familiar with how small businesses operate, and is willing to look at the big picture. They can sense whether a loan applicant is solid or shaky. This is the point at which you, the applicant, will want to put your best foot forward.

You may find that as long as you have substantial equity in a home, good credit, and adequate cash flow that you are a tasty morsel in the mouth of a loan officer. However, if you are short in any of these areas, you are going to have to overcome the banker's natural skepticism.

First impressions are paramount. If you are not organized, you are dead meat. If you are asking to borrow money, then you must possess the skills necessary to pay the money back. These are skills, such as, the ability to think and plan ahead, and the discipline required to operate your business in a professional manner. This means having the know-how to gather information and organize it in such a way that you can make meaningful and timely decisions.

Ask any banker and they will tell you of countless business customers that come in seeking a loan who don't even know what a financial statement is. There are many other business customers who seek loans that do have a financial statement but haven't a clue as to what it means. This does not bode well for first impressions.

Compare the individual who comes to the bank, nicely dressed, well groomed and possesses not only a financial statement that he/she understands, but has a plan as to how he/she will pay the loan back. This phenomenon is so rare that a banker will usually sit up and take notice.

If the reason you are short on cash and need a loan is because you are a poor manager who is in denial about your failing business, it will be obvious to the banker. Bankers are objective. They are not going to throw good money after bad. However, if you have a healthy business and you want to finance a new piece of equipment that will enhance your revenue earning capacity then your request will seem reasonable. Perhaps you need a line-of-credit to shore up your cash flow during less productive seasons, and you plan to pay back the line during productive seasons. These are the kind of stories that make good business sense to a banker.

To back up your story, you will need a Balance Sheet and Profit & Loss Statement that reflects the history of your business activity. Included should be an analysis of your business trends using some key business ratios. If the numbers look good, then go for the loan. Remember though, you can't rely on the banker to recognize all the positive aspects of your business, therefore, you should provide a narrative of how your business works and why the requested funds for the business will help you make more money.

**TIP: Selecting Useful Business Ratios For A Small Business.**

There are many types of business ratios. However, I have found that most of them are not applicable for the very small business. Sometimes the ratios are simply not worth the time or trouble to figure out because the owner is so intimately involved with the business that he/she already knows the information that can be derived from the ratio. Often, several ratios must be applied to get a full picture. The type, size, and complexity of the business will determine the appropriate ratios to use. As a matter of fact, there have been volumes written on the subject.

In my Real Life Accounting course, I suggest focusing on only five primary types of ratios and eight particular ratios most businesses find useful. My goal, in this article, is to give you an idea of what business ratios are and how they work. Since it is not possible to cover each of the eight particular ratios, I will discuss just three. From this you can expand your knowledge of ratios based on your individual needs. The five types of ratios and their related ratio formulas are as follows:

(1) **Liquidity** – Refers to the quality and adequacy of current assets to meet current obligations as they come due.

a. **Current Ratio =** $\dfrac{\textbf{Total Current Assets}}{\textbf{Total Current Liabilities}}$

b. **Quick Ratio =** $\dfrac{\textbf{Cash \& Equivalents + Trade Receivables}}{\textbf{Total Current Liabilities}}$

(2) **Leverage** – Refers to the solvency of the company.

a. **Debt to Equity Ratio =** $\dfrac{\textbf{Total Liabilities}}{\textbf{Total Equity}}$

(3) **Operating** – Refers to how the operations of the company are being managed.

a. **Sales/Receivables =** $\dfrac{\textbf{Net Sales}}{\textbf{Trade Receivables}}$

b. **Day's Receivables =** $\dfrac{\textbf{365}}{\textbf{Sales/Receivable Ratio}}$

c. **Cost of Sales/Inventory =** $\dfrac{\textbf{Cost of Sales}}{\textbf{Inventory}}$

(4) **Investment** – Refers to the company's ability to provide a reasonable return on the owner's investment.

a. **Return On Investment = $\dfrac{\text{Net Income (or Profit)}}{\text{Owner's Equity}}$**

(5) **Profitability** – Refers to the company's ability to earn an acceptable profit.

a. **Profit Margin = $\dfrac{\text{Net Income (or Profit)}}{\text{Total Revenue}}$**

**QUESTION: What Ratios Should I Use To Determine The Health Of My Business?**

Let's assume you are thinking about asking your bank for a loan. The first thing you should do is to pull together a financial statement of your business. You are going to use the Liquidity and Leverage ratios to see how things look. The information needed for these ratios can be taken off the following balance sheet:

**BALANCE SHEET**
**Your Company**
**As of December 31, 20XX**

| | | | |
|---|---|---|---|
| **ASSETS:** | | | |
| **Current Assets:** | | | |
| **Cash** | **$1000** | | |
| **Accounts Receivable** | **2000** | | |
| **Inventory** | **3000** | | |
| **Total Current Assets** | | **6000** | |
| **Fixed Assets:** | | | |
| **Equipment** | **5000** | | |
| **Furniture & Fixtures** | **7000** | | |
| **Total Fixed Assets** | | **11000** | |
| **Other Assets:** | | | |
| **Deposits** | **500** | | |
| **Prepaids** | **500** | | |
| **Total Other Assets** | | **1000** | |
| **TOTAL ASSETS** | | | **18000** |
| | | | **=====** |
| **LIABILITIES:** | | | |
| **Current Liabilities:** | | | |
| **Accounts Payable** | **500** | | |
| **Notes Payable** | **2000** | | |
| **Sales Tax Payable** | **500** | | |
| **Total Current Liabilities** | | **3000** | |
| **Long-Term Liabilities:** | | | |
| **Notes Payable** | **9000** | | |

| | | | |
|---|---|---|---|
| **Total Long-Term Liabilities** | | **9000** | |
| **TOTAL LIABILITIES** | | **12000** | |
| **EQUITY:** | | | |
| **Owner's Equity** | **5000** | | |
| **Owner's Draw** | **<1000>** | | |
| **Net Profit** | **2000** | | |
| **Total Equity** | | **6000** | |
| **TOTAL LIABILITIES & EQUITY** | | | **18000** |
| | | | **=====** |

Note: *Be sure to review the balance sheet so you can see where the numbers come from.*

The first ratio formula to look at is the Current Ratio, which is also known as the Working Capital Ratio.

$$\frac{\textbf{Total Current Assets}}{\textbf{Total Current Liabilities}} \quad \textbf{or} \quad \frac{\textbf{6000}}{\textbf{3000}} \quad \textbf{or} \quad \frac{\textbf{2}}{\textbf{1}}$$

This ratio is a rough indication of a company's ability to service its current obligations. Generally, the higher the current ratio, the greater the "cushion" between current obligations and a company's ability to pay them. A rate of 2:1 is considered satisfactory for most firms. This means you are looking pretty good so far. However, if those Accounts Receivables are old, or the Inventory is obsolete then $5000 of your $6000 may not be available to pay off those current liabilities of $3000. Best to look closer and we do that by using the Quick Ratio which is also known as the Acid Test Ratio.

$$\frac{\textbf{Cash \& Equivalents + Trade Receivables}}{\textbf{Total Current Liabilities}} \quad \textbf{or} \quad \frac{\textbf{1000 + 2000}}{\textbf{3000}} \quad \textbf{or} \quad \frac{\textbf{1}}{\textbf{1}}$$

This ratio is a refinement of the Current Ratio and a more conservative measure of liquidity. This ratio expresses the degree to which a company's current liabilities are covered by the most liquid current assets. A 1:1 value is considered adequate. As long as those Accounts Receivables are current you are still looking good. Might be a good idea to run the Sales/Receivables and Day's Receivable Ratios just to prove to the banker that your receivables are current and collectible.

You have demonstrated that the liquidity of the company is satisfactory. Next, you should look at the solvency of your company and you do that by using the Debt to Equity Ratio.

**<u>Total Liabilities</u> or <u>12000</u> or <u>2</u>**

| | | |
|---|---|---|
| **Total Equity** | **6000** | **1** |

Capital is raised through equity and/or debt. Debt capital is risky because if the lenders are not paid promptly, they can obtain legal action to obtain payment, perhaps even forcing bankruptcy. On the other hand, equity capital comes from owners who understand that they may not receive a guaranteed monthly payment. A company with a high proportion of debt is said to be highly *leveraged.* Lenders normally do not like to see debt that is 2 times higher than equity, or 2:1. Looks like you are okay but right up to the limit. You might mention in your narrative that your long-term liabilities are only $9000 which would indicate a 1.5:1 Debt to Equity Ratio. In other words, you have enough liquidity to handle your current liabilities so you are really only leveraged at a 1.5 to 1 ratio.

What's it all mean? It means your business is in good shape. It could be healthier, but it's decent. However, this is only part of your story. What are your plans? Who makes up your customer base? Is your business seasonal? Who are your managers or key employees? Are they well trained? What kind of internal controls do you have in place to ensure that your policies and procedures are followed? Do you have an employee manual? Telling your full story and backing it up by numbers, confirms the fact that you have your act together. This is what your banker is looking for.

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