

SMALL BUSINESS



FINANCIAL ANALYSIS IN THE SMALL FIRM

Financial ratio analysis is especially useful for small businesses, and readily available sources provide comparative data by firm size. For example, Robert Morris Associates provides comparative ratios for a number of small-firm classes, down to a size range of zero to \$250,000 in annual sales. Nevertheless, analyzing a small firm's statements presents some unique problems. We examine here some of those problems from the standpoint of a bank loan officer, one of the most frequent users of ratio analysis.

When evaluating a small-business credit prospect, a banker is essentially making a prediction about the company's ability to repay its debt. In making this prediction, the banker will be especially concerned about indicators of liquidity and about continuing prospects for profitability. Bankers like to do business with a new customer if it appears that loans can be paid off on time and that the company will remain in business and therefore continue to be a customer for some years to come. Thus, both short-run and long-run viability are of interest to the banker. Note too that the banker's perceptions about the business are important to the owner-manager, because the bank will probably be the firm's primary source of funds.

The first problem the banker is likely to encounter is that, unlike the bank's bigger customers, the small firm may not have audited financial statements. Further, the statements that are available may have been produced on an irregular basis (for example, in some months or quarters but not in others). If the firm is young, it may have historical financial statements for only one year, or perhaps none at all. Also, the financial statements may not have been produced by a reputable accounting firm but by the owner's brother-in-law.

The poor quality of its financial data may therefore be a hindrance for a small business that is attempting to establish a banking relationship. This could keep the firm from getting credit even though it is really on solid financial ground. Therefore, it is in the owner's interest to make sure that the firm's financial data are credible, even if it is more expensive to do so. Furthermore, if the banker is uncomfortable with the data, the firm's management should also be uncomfortable: Because many managerial decisions depend on the numbers in the firm's accounting statements, those numbers should be as accurate as possible.

For a given set of financial ratios, a small firm may be riskier than a larger one. Small firms often produce a single product, rely heavily on a single customer, or both. For example, several

years ago a company called Yard Man Inc. manufactured and sold lawn equipment. Most of Yard Man's sales were to Sears, so most of its revenues and profits were due to its Sears account. When Sears decided to drop Yard Man as a supplier, the company was left without its most important customer. Yard Man is no longer in business. Because large firms typically have a broad customer base, they are not as exposed to the sudden loss of a large portion of their business.

A similar danger applies to a single-product company. Just as the loss of a key customer can be disastrous for a small business, so can a shift in the tides of consumer interest in a particular fad. For example, Coleco manufactured and sold the extremely popular Cabbage Patch dolls. The phenomenal popularity of the dolls was a great boon for Coleco. However, the public is fickle — one can never predict when such a fad will die out, leaving the company with a great deal of capacity to make a product that no one will buy, and with a large amount of overvalued inventory. Exactly that situation hit Coleco, and it was forced into bankruptcy.

Extending credit to a small company, especially to a small owner-managed company, often involves yet another risk that is less of a problem for larger firms — dependence on a single key individual whose unexpected death could cause the company to fail. Similarly, if the company is family owned and managed, there is typically one key decision maker, even though several other family members may be involved in helping to manage the company. In the case of the family business, the loss of the top person may not wipe out the company, but it often creates the serious problem of who will assume the leadership role. The loss of a key family member is often a highly emotional event, and it is not at all unusual for it to be followed by an ugly and protracted struggle for control of the business. It is in the family's interest, and certainly in the creditors' interests, to see that a plan of management succession is clearly specified before trouble arises. If no good plan can be worked out, perhaps the firm should be forced to carry "key person insurance," payable to the bank and used to retire the loan in the event of the key person's death.

In summary, to determine the creditworthiness of a small firm, the financial analyst must "look beyond the ratios" and analyze the viability of the firm's products, customers, management, and market. Still, ratio analysis is the first step in such a credit analysis.