

What is Financial Analysis?

- Using financial tools:
 - Enterprise budgets

 - Income statements
- To identify a business' strengths and weaknesses
 - Helps the manager improve the business



Why is it Necessary?

- Financial Analysis:
 - Helps a manager take actions to improve the business
 - Identifies potential problems before they occur
 - Helps lenders analyze loan applications for strengths, weaknesses, and risks
 - Helps the manager understand the business more fully



Types of Financial Analysis

- Ratio Analysis
 - Use ratios and figures (net income, RAVC, etc.)
 - Compare those ratios and figures to "benchmarks"
 - Benchmarks are "goals" or "standards"
- Trend Analysis
 - Look at changes in ratios and figures over time
 - Are they improving or getting worse?



Main Areas of Analysis

- Liquidity
 - Having enough current assets to cover your current liabilities
- Solvency
 - Having enough total assets to cover your total liabilities
- Profitability
 - "Are we making money above our expenses?"
- Financial Efficiency



Liquidity Analysis

- Use the Balance Sheet
- Current Ratio is the main measure
- Current Ratio = Current Assets / Current Liabilities
- Like to see:
 - A minimum ratio of 1.0
 - Greater than 2.0 is strong
- - A Current Ratio of 2 means that you have \$2 of current assets for every \$1 of liabilities that are due within the next year (current liabilities)



Solvency Analysis

- Use the Balance Sheet
- Debt/Asset Ratio is the main measure
 - Debt/Asset Ratio = Total Liabilities / Total Assets
- Like to see:
 - Less than 40% for an existing business
 - Less than 705 for a new or start-up business
 - Decreasing over time



Solvency Analysis

- Interpretation:
 - A Debt/Asset Ratio of 40% shows that you owe your lenders 40% of the value of your assets
 - Or that you have paid for 60% of your assets
 - Another way to look at it:
 - Your lenders "own" 40% of your assets
 - You own 60% of your assets



Profitability Analysis

- Use the Income Statement or Enterprise Budget
 - Gross Margin or Return Above Variable Costs
 - Net income or Return Above Total Costs
- Also need the Balance Sheet
- Main ratio is Rate of Return on Assets (ROA)
 - ROA = (Net Income + Interest) / Total Assets



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Profitability Analysis

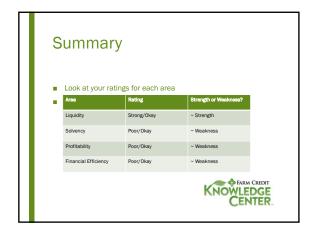
- Like to see:
 - ROA > 0% at a minimum
 - ROA > interest rate (APR) on your loans
 - ROA > 8% is strong
 - Growing over time
 - The higher, the more profitable your business
- - An ROA of 10% means that you earned \$0.10 of profit for every \$1 of asset used in your business.

 FIRM CREDIT KNOWLEDGE



Financial Efficiency Analysis

- We're just focusing on cost control here
- Use the Income Statement
- Operating Expense/Receipt Ratio
 - Op. Exp/Rec = (Total Exp. Int. Dep.) / Total Revenue
- Like to see:
 - Less than 75%
- Interpretation:
 - A ratio of 75% means that the business spends \$0.75 in expenses to generate \$1 of revenue



Summary

- Now the manager can see what areas need to be improved!
- Main ways to improve a business:
 - Reduce the top 5 expenses
 - Without hurting production
 - Increase revenues
 - More units produced & sold
 - Different price
 - Get rid of unneeded or un-used assets



Summary

- A manager must look at the financial and the production aspects of the business
 - They are directly related!!
 - Too often the financial aspects are ignored
- Lenders use this same analysis to review loan applications
 - Managers should know their own strengths and weaknesses BEFORE meeting with the lender!

