PN-ABM-183

79141

WORKSHOP PREVIEW

TRAINERS' GUIDE AND MANUAL

Presented By

DEVELOPMENT ASSOCIATES, INC.

In Conjunction with

PRICE WATERHOUSE

Presented For

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT/
BUREAU FOR PRIVATE ENTERPRISE

March 1990

TABLE OF CONTENTS

PREVIEW AGENDA v

CREDIT ANALYSIS. 1

ANALYSIS OF THE OVERALL HEALTH OF A SMALL BUSINESS 6

INTER-RELATIONSHIP OF BALANCE SHEET, PROFIT, AND LOSS, AND FUNDS FLOW STATEMENT 14

LIFE CYCLE OF A SMALL BUSINESS 35

FINANCIAL PITFALLS AND DANGER SIGNALS FOR SMALL BUSINESSES 60

CREDIT AND FINANCING 65

TOOLS AND TECHNIQUES USED BY BANKERS IN ANALYZING LOAN REQUESTS. 81

REASONS FOR FAILURE OF SMALL BUSINESS. 101

CASE STUDY ANALYSIS. 108

PREVIEW AGENDA

I. Introduction

The preview of the workshop on Financial Analysis for Borrowers and Lenders is being condensed into a two-day version of the training manual and teaching modules (or sessions) to be given over the proposed five-day workshop schedule.

As a result, a decision had to be made on how to present the preview in order for participants to get the best picture of the entire process. Essentially, we had three options: (1) to give a condensed version of the complete training manual (2) to select a sample of training sessions and present them in full sessions (3) to present a select sample of training in condensed sessions.

The first option would force presenters and viewers to rapidly run through the entire five day training manual in two days, which would seriously limit exploring any one session in depth. The second option would seriously limit the opportunity to view the variety and range of training topics. We chose the third option because it will provide viewers an opportunity to see a number of training sessions treated in some depth, and can be easily accomplished during two day preview.

The next decision was to select the training sessions for presentation. We wished to conduct training in the topics which seem to be the most important and key areas of the workshop in terms of the participants. Also, it seemed desirable to achieve some balance between issues of relevance specifically for bankers and business firms as well as topics of mutual interest to both groups. This was the basis for developing the preview agenda.

Some remarks are appropriate at this point in terms of the types of participants who will be recruited for the workshops. From the bankers or lenders side, we anticipate that junior and mid-level credit officers will be the principal focus. From the entrepreneur side, we expect business firms that have assets up to $250,000 excluding land and buildings.

Finally, we recognize PRE's main objectives and priorities in supporting the workshops as a means for promoting institutional and attitudinal change affecting lenders' policy toward granting credit for small business. We also

are aware of the emphasis to be placed on the importance of cash flow versus collateral in the credit process and practices of lending institutions. These key issues will be emphasized, where appropriate, during the workshop sessions, and have been made explicit in the training session narrative.

Another key aspect of the workshop training will be sensitizing participants to other important AID issues. One of these issues is opening up opportunities for women and utilizing women effectively through projects supported by Women in Development (WID). Another global issue which is of concern worldwide is the impact of the business (and business loan guaranty) on the environment and relevant environmental factors. These issues will be incorporated appropriately in the workshop sessions.

II. Preview Activities

The preview begins with a brief description of what occurs during the introduction of the actual workshop agenda. Certain participation activities required of the participants are omitted from the preview to conserve time; but a summary of the workshop kickoff will be presented. (See Appendix 1. for Summary Introduction.)

The first session following the Introduction is Credit Analysis.

1. Credit Analysis

This module or training session leads off both the actual workshop and the preview because it is the core of the project's objective and provides the foundation for improving financial skills of borrowers and lenders. It is the common bond that brings them together and is the basis for the ultimate goals of borrowers - to secure credit - and of lenders - to give a good loan. This session will provide an opportunity for lenders and borrowers to know each other's problems.

Furthermore, the session will focus on the various measures available to lenders in objectively evaluating the general health of a small business enterprise including financial, product, marketing and management indices. Both lenders and borrowers will benefit from gaining a better understanding of the standards that are important in lending and borrowing decisions.

2. The Inter-Relationship of Balance Sheet, Profit and Loss and Funds Flow Statement

The next session provides a perspective on the mechanics of financial analysis, one of the key elements needed to secure credit. Entrepreneurs need to know how to analyze small business finances and understand the basic concepts and fundamentals of accounting.

3. Life Cycle of a Small Business

This session focuses on the various "cycles" of a small business and offers useful information for borrowers in analyzing their business' present and future growth potential.

4. Reasons for Small Business Failures

Understanding important data, trends and reasons for business failures is essential for borrowers. Also this session will assist borrowers and discuss their needs with bankers during various cycles in terms of credit and loan decisions.

5. Financial Pitfalls

This session is important for small business in terms of financial decisions and the pitfalls to avoid. This is especially important when financial decisions may spell disaster for an otherwise sound business.

6. Credit and Financing

This session focuses on the key elements which determine lending policy, credit rating and how banks deal with small business.

7. Tools and Techniques Used by Bankers in Analyzing Loan Requests

The critical tools and techniques used by bankers in analyzing loan requests is designed to sharpen the financial skills of credit officials and other staff dealing with small business lending.

8. Case Study

The last item on the Preview Agenda is a description of the case study methodology to be used in the workshop. The rationale for employing this exercise in the agenda and the process of carrying it out will be the main focus of this session. One of the basic purposes of employing case studies from participants is to relate relevant, real-life experiences to the content of the workshop training sessions.

This concludes the Preview Schedule. As can be noted, three of the sessions are addressed to both groups, four are focused on business and three on bankers for a balanced preview of the workshop training.

WORKSHOP AGENDA

I. INTRODUCTION

The purpose of this workshop is to assist both lenders and small business borrowers in financial analysis. The training will include basic financial accounting concepts, the importance of financial accounting, cash flow, the impact of taxation on small business, the analysis of financial statements and other practices essential to effective business management.

This workshop is being sponsored by the Bureau for Private Enterprise, Agency for International Development (AID) under the Financial Sector Development Project (FSDP) for which Price Waterhouse serves as prime contractor. Development Associates, as a subcontractor, is responsible for conducting the workshops.

The AID Private Enterprise Bureau has given priority to support and enhance the private sector through different programs, including loans to private local financial institutions for lending to small and medium sized business. The experience with these programs has been positive and indicates a continuing need to support the entire credit process affecting small business development.

PREVIEW AGENDA

		Primary Focus
FIRST DAY		
08:30 - 09:00 A.M.	Introduction/Purpose of Workshop	Groups A & B
09:00 - 10:30 A.M.	Credit Analysis - Part I	Groups A & B
10:35 - 10:45 A.M.	Coffee Break	
10:45 - 12:00 A.M.	Analysis of the Overall Health of a Small Business	Group B Businesses
12:00 - 01:00 P.M.	Lunch	
01:00 - 02:00 P.M.	Inter-Relationship of Balance Sheet	Group A Bankers
02:00 - 03:00 P.M.	Life Cycle of a Small Business	Group B Businesses
03:00 - 03:15 P.M.	BREAK	
03:15 - 04:30 P.M.	Reasons for Small Business Failures	Group B Businesses
04:30 - 05:30 P.M.	Discussion	
SECOND DAY		**Primary Focus**
08:30 - 10:00 A.M.	Financial Pitfalls	Group B Businesses
10:00 - 10:15 A.M.	BREAK	
10:15 - 11:30 A.M.	Credit and Financing	Group A Bankers
11:30 - 12:00 Noon	Discussion	
12:00 - 01:00 P.M.	Lunch	
01:00 - 02:30 P.M.	Tools & Techniques (Used by Bankers)	Group A Bankers
02:30 - 02:45 P.M.	BREAK	
02:45 - 04:00 P.M.	Case Study Methodology and Process (Business)	
04:00 - 05:30 P.M.	Discussion/Wrap-up	Groups A & B

TRAINER'S GUIDE

SESSION:	CREDIT ANALYSIS (PART I)
Groups A and B:	Credit Officers & Entrepreneurs
Total Time:	60 minutes

A. Teaching Objectives

1. Provide an overview of the session to outline for the group the two evaluation systems used in making sound credit decisions; to give an understanding of the main principles of credit analysis.

2. Discuss the main tenets of the judgmental approach to granting credit (the 5 C's).

3. Emphasize the advantages, disadvantages, and justification of the credit scoring approach.

4. Discuss the two systems from the group's point of view.

B. Suggested Teaching Techniques

Introduce the two credit evaluation systems and the three principles of credit analysis. Explain the importance of credit evaluation and sound decision-making to the success of banks and other credit institutions.

Discuss how a bank's policy guidelines go together with the 5 C's of credit to form the judgemental approach to evaluation. Show transparencies.

Go through the credit scoring approach, and highlight its advantages, disadvantages, and justification. (Note that it is used primarily in large banking institutions. Usually small banks rely on the judgmental approach.)

Break

Open the discussion to the group and list any problems, issues, and comments on a flipchart. Use their remarks for an enhanced discussion on the two systems.

Materials:	Pencils, pads.
Exhibits:	
Overhead/ Visuals:	Pie graphic on the C's of credit, credit analysis diagram.
Equipment:	Projector.

SESSION: CREDIT ANALYSIS

Objectives:

1. To provide participants with the knowledge of those factors essential to sound credit decisions.

2. To understand the three fundamental principles of credit analysis and decision-making.

3. To emphasize the importance of cash flow in the credit analysis.

Groups A and B: (Credit Officers and Entrepreneurs)

Activities: Introduction - Part I

The purpose of this session is to provide participants with the necessary tools to effectively evaluate a bank credit. The primary responsibility of credit quality rests with the credit officer. The credit officer is the person who has access to a borrower and has the responsibility to gather the necessary data to do an appropriate credit analysis. It is important to understand that credits are repaid in the future, the result of credit analysis should be formulation of an opinion as to whether the credit taker will have funds available in the future when the payment on the loan is due. Analysis of statistical information and historical data, such as balance sheets and income statements are useful to the extent that it helps predict the future.

A thorough review of the business will inevitably reveal not only the potential risks but also opportunities for other services the bank may offer.

A detailed analysis of a borrower will involve financial condition and performance.

The importance of credit evaluation and sound decision-making to the success of banks and intermediate credit institutions cannot be too strongly emphasized.

1. The three principles of credit analysis are:

   - Make the best loan for the customer and the bank.
   - Ensure that the level of credit risk is acceptable.
   - Ensure compliance with regulations and bank policy.

2. The Credit Evaluation Systems

   - Judgmental
   - Credit Scoring

3. Judgmental Approach

- Legal - bank policy guidelines
- Character-stability, credit history
- Capacity-financial ability
- Capital-backup assets
- Collateral-specific pledged assets
- Conditions-economic/outside influences

4. The Credit Scoring Approach - an attempt to quantify the judgmental system

Advantages of System

- increased management control
- reduced loan processing costs
- more legally defensible system
- easier training of new employees
- facilitates data gathering

Disadvantages of System

- applies a standard objective system to all applicants
- expensive
- requires monitoring

Justification for the System

- the size of bank loan portfolio
- type of financial institution
- satisfaction with their present credit evaluation syste

EXHIBIT 3

CREDIT ANALYSIS PROCESS

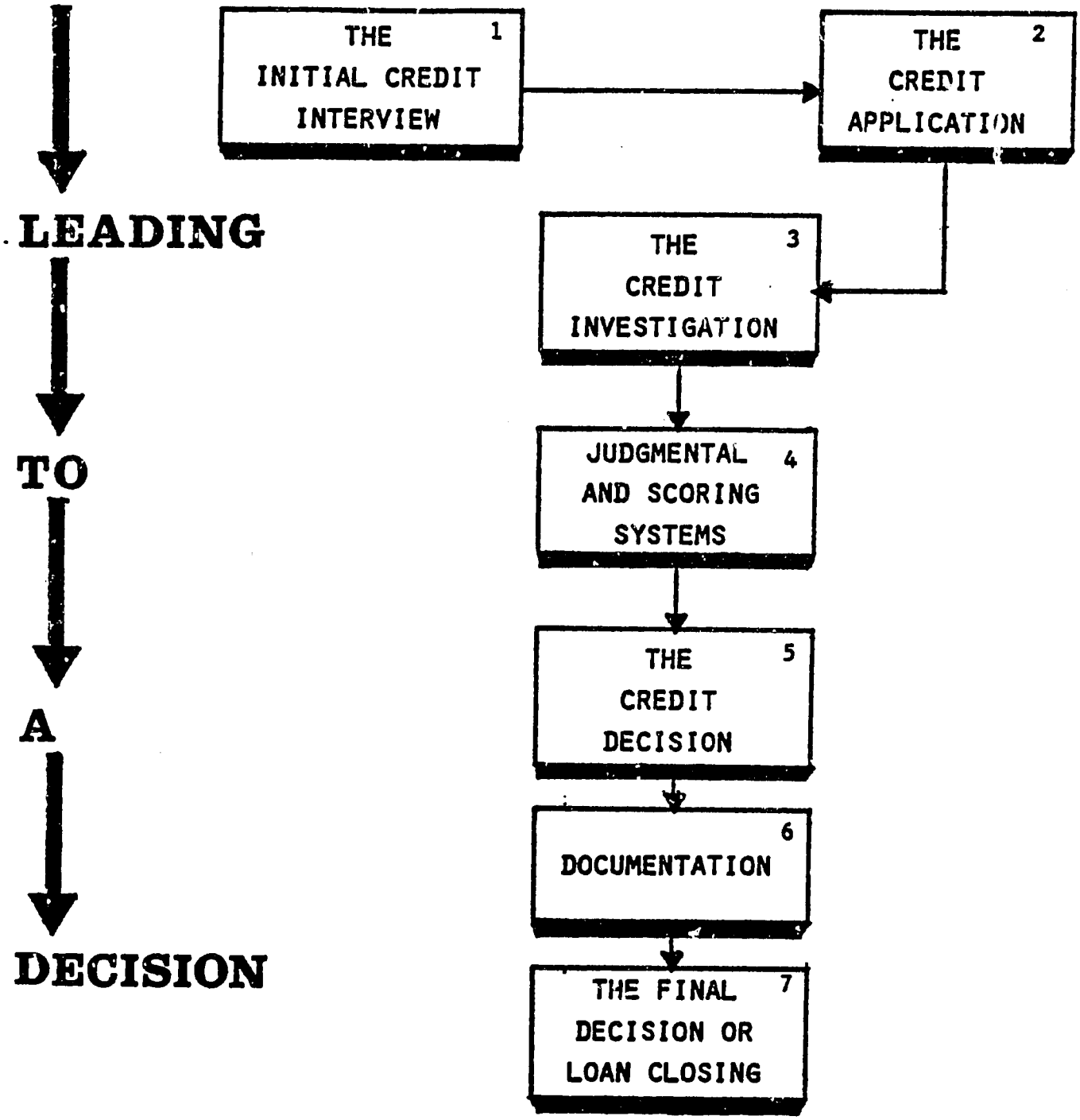
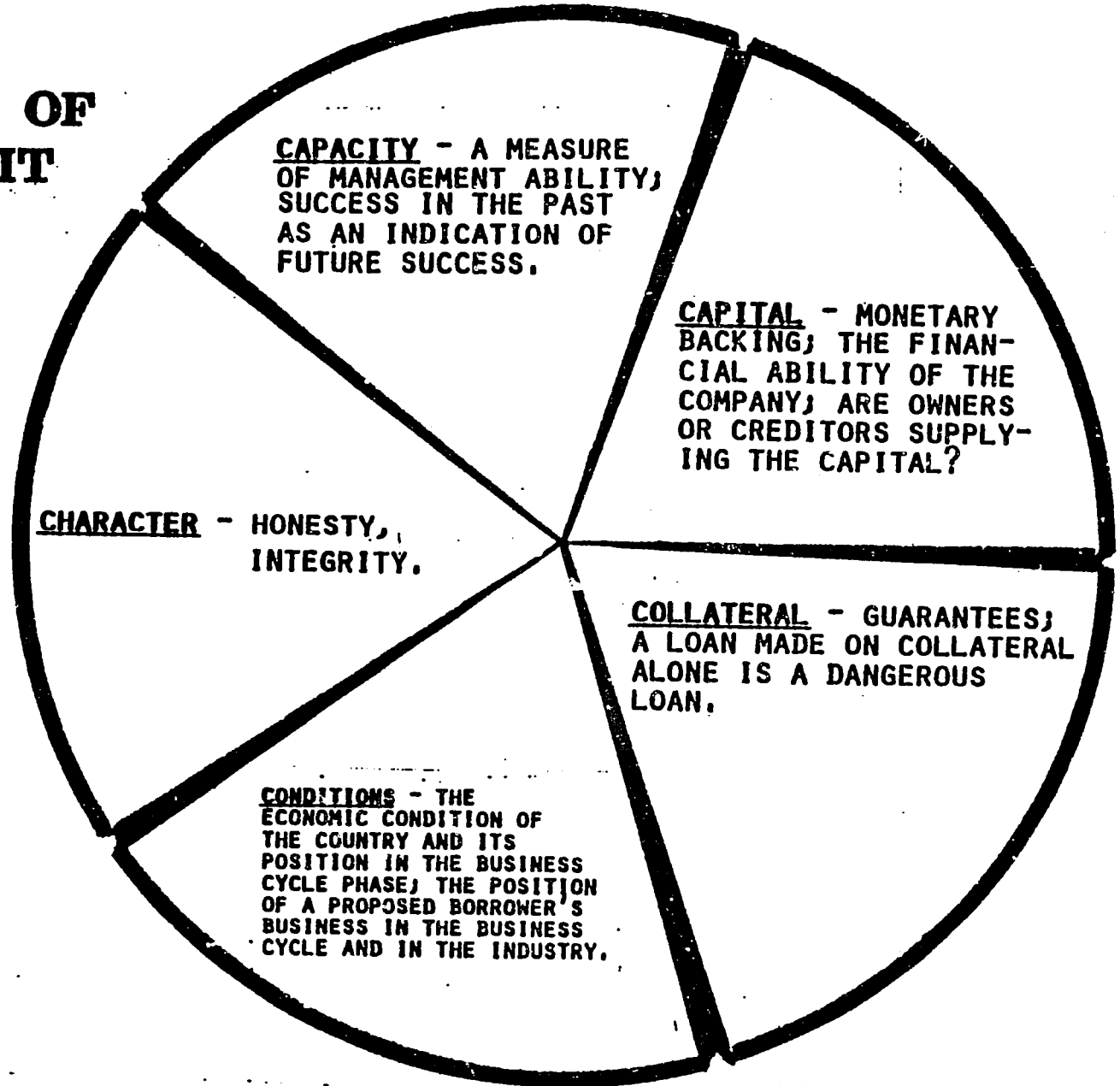


EXHIBIT 4

THE C's OF CREDIT



"A LOAN WELL-MADE IS A LOAN HALF COLLECTED"

TRAINER'S GUIDE

SESSION:	ANALYSIS OF THE OVERALL HEALTH OF A SMALL BUSINESS
Group A:	Credit Officers
Total Time:	3 hours

A. Teaching Objectives

1. Discuss the borrower's products and markets.
2. Discuss the borrower's production strategy.
3. Evaluate the borrower's management capabilities.
4. Evaluate the borrower's financial condition and performance record.
5. Discuss financial risk management.
6. Evaluate the borrower's forecast capabilities.

B. Suggested Teaching Techniques

Open the session with an introduction to the critical functions of evaluating the method used to analyze the small business enterprise. Stress the importance of obtaining current and accurate financial information to support your analysis. There are three types of records: The obviously good, obviously weak, and the borderline. The obviously good record should not be just filed. It should be thoroughly reviewed. The obviously weak record should be examined for favorable factors and checked for the cause of the weakness and determine whether it can be corrected. The borderline cases are the ones that test the ability and imagination of the banker to correctly make a decision.

Discuss how a banker interprets financial records properly. He keeps prominently in mind five considerations: (1) the amount of loan desired; (2) the purpose for which proceeds are to be used; (3) the period of time for which the loan is desired; (4) the sources from which repayment funds will come; and (5) alternative sources of repayment if intended means do not materialize. Stress the fact that the quality of the financial record and a clear knowledge of these factors are very important in determining the type and extent of credit analysis to be completed.

Discuss the management quality. The single most important thing about management is its integrity. No matter how many pages of a legal agreement you have prepared, there, is no agreement that can protect you from somebody who is going to purposely cheat the bank. How good is management at exercising the skills of management. The integrity, ability, and experience of management are the qualities needed in abundance to have a successful business operation. Discuss depth of management. (Family owned)

Break

Discuss the major items in the financial statement. A detailed analysis of the business will involve its financial condition and performance. Stress the need to examine the quality of each financial statement item.

Accounts Receivables

Examine the quality of receivables. Look at the aging and concentration of receivables.

Inventory

Review inventory turnover. What is the trend in their level of inventory? Is the valuation of inventory realistic?

Fixed Assets

How are fixed assets valued? Method of depreciation. Consider investment in new equipment, how will it be financed and under what terms and conditions.

Intangible Assets

Any item that is susceptible to evaporation should be evaluated and deducted to arrive at the tangible net worth.

Accounts Payable

Consider company's payables in absolute amount; as a percentage of total assets; and, of year's total purchases. What is aging of payables?

Contingent Liabilities

Always be aware of any undisclosed liabilities. Examine any noted contingent liabilities such as pending litigation, guarantees, and leases.

Net Worth

Examine net worth in absolute terms. Do not add subordinated debt to equity. Review any revaluation of assets.

Liquidity

Examine the working capital. How hard is the borrower making its working capital work to produce revenue? Is there a danger of overtrading and being vulnerable to liquidity problems?

Review the course material and open the session to class discussion. The participants should be asked their experiences and what they have learned from the material presented. You should stress that many things can adversely impact a business. The risks are many (economic, political, social, and technological are some risks) which should be considered in your evaluation of a small business.

Materials: Pencils, Pads.
Exhibits:
Overhead/
Visuals:
Equipment: Flipchart.

SESSION: ANALYSIS OF THE OVERALL HEALTH OF A SMALL BUSINESS

Objectives: To understand and evaluate the solvency of a business through an indepth analysis

Group A: Credit Officers

Activities: Introduction

The purpose of this session is to provide the credit officer with a ready reference for analyzing a small business enterprise. It is important to understand that the responsibility for the quality of credit extended by a bank lies with the officer who recommends a loan. In determining the financial health of the business, the credit officer must gather information necessary for a proper financial analysis.

There is a tendency to concentrate analysis on quantifiable variables as opposed to qualitative factors, since it is easier to argue a point with a set of numbers in hand than with some nebulous ideas. Once a person becomes engrossed in the financial statement analysis, he will be strongly influenced by statistics. It is necessary that the credit officer understand the strategic factors which influence the small business enterprise.

Since no business operates in a vacuum, it needs to be stressed that an analysis of all individual elements of the business needs to be performed in light of its environment. Questions to consider: how will it be affected by economic changes, political and regulatory changes, by changes in social or cultural conditions, and by changes in technology? A credit analysis should also include analysis of stated strategy (i.e. the business strategy as stated by the owner/manager), by its revealed strategy (the way it actually performs).

A thorough review of the business will reveal not only the potential risks but also opportunities for other services the bank could provide to the borrower. In fact, risk and opportunity are inseparable in this regard. The analysis will uncover opportunities and the risks will stimulate creativity to formulate new ideas to overcome any deficiencies noted.

General Application to Banks

1. The Evaluation of the Business

a. General Considerations

Evaluate the borrower's business in light of changing world conditions.

- Consider the impact of economic changes such as those associated with recession and inflation.

- Consider changes in geo-political or military factors.

- Changes in technology which could affect borrower's market or production processes.

- Social or cultural conditions may affect a borrower's market.

- Consider political and regulatory changes which could affect sales and distribution within the market.

These conditions should be kept in mind throughout the analysis of the business and the credit officer should continue asking how the changes affect the borrower's business.

b. <u>The Borrower's Products and Markets</u>

- Have a clear and concise understanding of the borrower's products.

  - What is the product or service produced? Consider the future saleability of product and impact of technology changes.

  - Consider quality of product.

  - Consider whether product is essential. (Is it seasonal or specialized?)

- The second aspect to consider is the borrower's customer base.

  - Who are the customers? Consider size, future needs, and income level.

  - How credit worthy are the customer's of borrower? If end-customers have problems, the borrower will eventually have trouble collecting receivables.

  - Concentration of risk among the customers of borrower. These are customers with a base of only a few companies, one industry, or companies dependent on one contract such as a government contract.

- Borrower's share of market.

  - Determine current share of market.

  - Determine the position of your borrower in the life cycle analysis. Is it a growing, mature or a dying business?

- Evaluate borrower's marketing methods.

  - Determine the borrower's pricing policy. Does it tend to price goods and services rather high or low? Flexibility in pricing may permit borrower to compete more effectively to maintain or increase its market share.

  - The borrower's distributors can present problems when they are not adequately capitalized. The banks borrower may suffer poor sales should the distributor provide poor delivery or fail financially.

- Evaluate the competition.

  - Who are competitors or potential competitors? Can they introduce a new product and render the borrower's products obsolete?

c. <u>The Management</u>

- Consider the general management.

  - The most important management consideration is integrity.

  - Consider management ability — What are demonstrable skills and does it have an able manager at all levels?

  - Consider experience in the business.

  - Depth of management (people and skills).

  - Control and planning systems are to be considered.

  - Consider attitude to risk and reward. Many companies do not take adequate risks because they do not have competent people to identify risks, assess them, and make a decision based on an intelligent assessment of risks.

- A detailed analysis will involve the financial condition and performance of the borrower. Following are some items which need to be verified?:

  - Examine major items in the business financial statement

  - Income - How it is recognized (cash)

  - Tax payments - trends

  - Cash flow - cash available to service debt (this is a very important factor)

- Accounts receivable - quality (examine)

- Inventory - turnover (trend-evaluation)

- Fixed assets - How valued (mortgaged)

- Intangible assets - goodwill, patents, deferred expenses, etc.

- Contingent liabilities - guarantees, litigation, leases or potential tax claims.

- Net worth - examine in absolute terms - do not exclude subordinated debt from liabilities. Check on any substantial revaluation of assets.

- Trend - examine trend of major items in the financial statement. Ask about sales declines or increases. Are profits increasing or declining? Do a comparative analysis against the performance of other like businesses. Trend analysis gives a fairly good indication as to the direction in which management is leading the company.

- Financial risk management.

  - Consider the company's capital. One should not lend to a company that does not have enough capital in proportion to credit. Does the business owner invest as much as the bank to keep him interested and working hard in the company even when things go wrong?

  - Overall financial condition - is it underleveraged, overleveraged or considered acceptable? Do a (sensitivity analysis) to indicate effects on the company of a decline in sales or rise in costs at varying levels.

  - Consider business expansion plans. Are they well thought out? Is is expanding too fast?

  - How are liabilities managed? Are maturities of debt matched with cash flow? Is the company borrowing short-term funds for long-term investments?

  - Does company have foreign exchange risk? Does company hedge any exposure?

- What are the borrower's forecasts?

  - Consider assumptions. Are they realistic?

  - Has borrower taken into account the servicing of new debt?

- Borrower's forecast will tell how realistic its management is and how rapidly it plans to expand.

- Check borrower's arithmetic in its forecasts.

d. <u>What Are the Borrower's Sources of Repayment</u>?

- There are three sources possible:

  1. Cash flow from the operations
  2. Conversion of assets to cash.
  c. The transfer of financing to another party.

The conversion of assets is risky because it is expensive to liquidate collateral and it may deteriorate in value. Accounts receivable that are taken in guarantee may become difficult to collect if your borrower goes into liquidation.

TRAINER'S GUIDE

SESSION:	INTER-RELATIONSHIP OF BALANCE SHEET, PROFIT AND LOSS, AND FUNDS FLOW STATEMENT
Module B:	Funds Flow Statement
Group A:	Credit Officers
Total Time:	45 minutes

A. Teaching Objectives

1. To provide definitions of funds and funds flow analysis. To provide a graphic example of a funds flow.

2. To describe Funds Flow Analysis in more detail; to introduce the Law of Funds Flow and the concept of sources and uses.

3. To add more detail on activities that generate sources of funds and activities that involve using funds ("where got" "where gone").

4. To provide examples of how the balance sheets income statement, and statement of sources and uses of funds are interrelated.

5. To conduct a case study (optional)

6. To summarize the session and emphasize the inseparability of statement of sources and uses of funds, from balance sheets and income statements. Provide examples of other names for statements of sources and uses of funds.

B. Suggested Teaching Techniques

Begin with an open discussion of funds and funds flow analysis. Refer participants to exhibit of a funds flow (graphic). This is the "ABC" company example. Show transparency.

Continue with discussion of Funds Flow in more detail; handout the basic definition of funds flow; go into the law of funds flow and the concept of sources and uses of funds. Refer participants to an example of a statement of sources and uses of funds for a company and for a bank. Discuss them briefly using the overhead projector.

Elicit examples from the participants of other sources and uses of funds. List their ideas on a flip chart in two columns, one for sources and one for uses.

Break

Go through the example of ABC company's sources and applications of funds. Refer participants to examples of a balance sheet, income statement, a funds flow statement and a chart showing relationships among Financial Statements.

Sum up the discussion by first asking for questions and relating them to the session's content. Relate the importance of the interdependence of the three types of statements in a thorough credit analysis.

Materials: Pencils, pads.

Exhibits: A basic definition of funds flow analysis; a graphic funds flow; examples of balance sheets, income statements, and statement of changes in financial position.

Overhead/ Visuals: The graphic funds flow model and statements.

Equipment: Projector, flipchart, and magic markers.

SESSION: INTER-RELATIONSHIP OF BALANCE SHEET, PROFIT AND LOSS, AND FUNDS FLOW STATEMENT (continued)

Objectives: To review relationship of financial statement.

Module B: Funds Flow Statement
Group A: Credit Officials

Activities: Introduction

A fund is "a measurable resource of a company or a person." All of the items on a BALANCE SHEET represent funds. Cash is, of course, the most obvious and easily recognizable example of a fund because it is liquid and often referred to as funds. However, accounts receivable, inventory, fixed assets are also funds.

Also, liabilities and net worth represent funds. (They were sources of funds used for the purchase of various assets.)

IN SHORT, EVERYTHING ON THE BALANCE SHEET IS A FUND.

1. Funds Flow

- Funds Flow Analysis (focuses on management's decisions on deployment of assets, liabilities, and net worth. Definition of funds flow analysis is preparation of a statement of sources and uses of funds. This statement is basic to the analysis of a business.

- Preparation of a Statement

  - Law of Funds Flow: for every use of funds, there must be an offsetting source of that fund.

- Sources and Uses

  - Sources:
    (1) Decrease in asset
    (2) Increase in a liability
    (3) Increase in stock
    (4) Profits before writeoffs

  - Uses:
    (1) Increase in asset
    (2) Decrease in a liability
    (3) Decrease in stock
    (4) Losses before writeoffs

2. It is important to recognize how a statement of changes in financial position (funds flow statement) is directly related to a balance sheet and income statement.

- Source and application of funds

- ABC Company

  - Balance sheet
  - Income statement
  - Sources and uses of funds for ABC Company

3. Summary of Session

- Accepted accounting principles usually require that the statement of sources and uses of funds accompany the income statement and balance sheet. (NOTE: all bank spread sheets have (should) a place for preparation of a statement of source and application of funds. <u>This statement can be called by many names and take many forms</u>.)

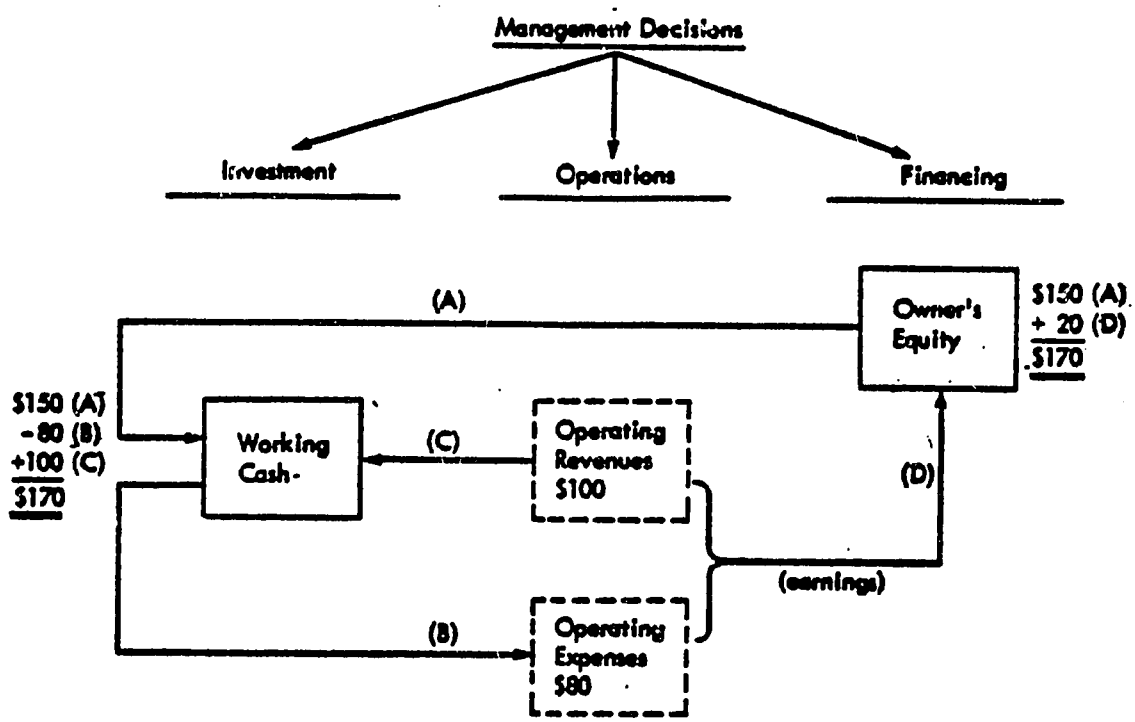
TEACHING AIDS

EXHIBIT 1

Funds Flow Analysis

Funds Flow Analysis is a comparative process which identifies shifts in financial condition and the impact of operations. It structures these into a framework of resources (funds) uses or applications, and resource (funds) sources or provisions. The resulting "decisional" view of business operations provides additional insights beyond the balance sheet, which is a mere static "snapshot" of financial condition at a point of time, and beyond the standard operating statement, which is a summary of revenue and expenses applicable to the period. Since it does add insight, the inclusion of a Funds Flow Analysis statement has in recent years, been made mandatory for the accounting reports of publicly traded companies to obtain a more dynamic picture of management decisions.

EXHIBIT 2
FUNDS FLOW MODEL 1 (ABC COMPANY)
CASH TRANSACTIONS ONLY



Balance Sheets

	Beginning of Period	*End of Period*	*Differences*
Assets			
Cash	$150	$170	+20
Liabilities			
Owner's equity	$150	$150	-0-
Retained earnings	-0-	20	+$20
Total Liabilities	$150	$170	+$20

Operating Statement

	Period
Operating revenues	$100
Operating expenses	80
Earnings for Period	$ 20

Funds Flow Analysis

a. To start up the business:

Use of Funds
Cash balance established $150
Source of Funds
Owner's investment $150

b. To operate the business for one period:

Use of Funds
Increase in cash balance $20
Source of Funds
Profit from operations (retained earnings) $20

SIMPLIFIED VIEW OF A BUSINESS

It may be best to illustrate the analysis by taking a very simplified example of a business and adding realism step by step. For this purpose, we shall employ the example of a man operating as a news vendor. Initially our vendor is selling papers on the street corner, without a booth or any equipment. He has invested some of his savings in a working cash fund, which is the only investment required to operate.

The model in Figure 1-1 shows the operations of this very simple business. Financing is provided by the owner in the form of $150 (A), shown as owner's equity and a working cash balance. During the day, $80 (B) of this working cash is spent to pay for newspapers, while revenues of $100 (C) are received. The profit or earnings from operations, $20 (D), in effect increases the working cash balance to a net of $170, and this increase is also reflected in owner's equity as earnings. Note that the investment (asset) item, working cash, and the financing (liability and networth) item, owner's equity, are shown in solid frames, while the periodic operating (profit and loss) items, revenues and expenses, are shown in dashed frames to reflect their temporary nature.

We have drawn up simple balance sheets at the beginning and at the end of the day, showing the effect of these transactions. It is clear that the day's operations have provided a $20 increase in cash, and an offsetting increase of $20 in owner's equity. This is the only difference between the two balance sheets. The operating statement for the period reflects the profit of $20.

We can now turn to funds flow analysis, but not before defining our ground. In this instance, it is possible to analyze two distinct phases, the establishment of the business and the operation of the business. This distinction does not have to be made, but since we are interested in the effects of major decisions, it may be useful to establish the separation. The first analysis, the startup of the business, shows that our vendor used $150 worth of cash to establish his working cash balance. The source of these funds was his own private savings. The second analysis, which spans the day's operations, shows that the changes in the funds picture are a use of funds of $20, which increased the working cash, and a source of funds of $20, which is the profit from operations. As we shall see in later sections of this chapter, the selection of time periods is a critical aspect of funds flow analysis, since the impact of decisions we are trying to picture may be obscured if too long a time period is chosen.

Several things become apparent from this simple illustration. First of all, we find that funds flow analysis is very closely related to the normal decision-making process of the business.

In fact, one could carry funds flow analysis to the extreme and display every single transaction that took place during the period in terms of sources and uses. This is unnecessary and impractical for most purposes, since we should be satisfied to reconstruct only the major resource decisions of the period.

Second, we find that funds flow analysis is very closely related to the accounting statements, the balance sheet and the income statement. As pointed out before, funds flow analysis focuses on the differences between periodic statements. While oversimplified here, the process is readily apparent.

Third, as we already pointed out, it is important to recognize that funds flow analysis is related to a time span. We must choose the period over which funds movements are to be observed, and analysis and judgments must be related to those time periods. In this simple case, the only question that comes to mind is the fact that $20 of funds has been committed to an increase in the cash balance. One might ask if it was reasonable to let this cash accumulate, or whether a different, better use for these funds might have been found by the owner.

EXHIBIT 3
QRS CORPORATION
STATEMENT OF CHANGES IN FINANCIAL POSITION, CASH BASIS
FOR THE YEAR ENDED DECEMBER 31, 19X (the current reporting period)

Sources of cash:		
From operations:		
Income before extraordinary items (accrual basis)...	$ 80,000	
Add (deduct) items to convert to cash basis:		
Depreciation expense.....	30,000	
Increase in accounts receivable.....	(25,000)	
Increase in inventory.....	(36,000)	
Decrease in prepaid expense.....	2,000	
Increase in accounts payable.....	28,000	
Decrease in income tax payable.....	(2,000)	
Net cash inflow from operations.....		$ 77,000
From extraordinary items (net of income tax).....		20,000
From other sources:		
Borrowing on short-term note.....	47,000	
Sale of Allstar's common stock.....	45,000	
Sale of operational assets*.....	25,000	117,000
Total cash inflow from all sources.....		214,000
Uses of cash:		
Payment of long-term notes.....	30,000	
Purchase of operational assets.....	100,000	
Purchase of long-term investment, Y Corp.....	50,000	
Payment of cash dividends.....	50,000	
Payment of cash dividents.....	40,000	
Total cash outflow for all purposes.....		220,000
Net increase (decrease) in cash during the reporting period.....		(6,000)
Direct exchanges not affecting cash (Note A).....		$140,000

Note A: The company purchased land at a cost of $140,000; full payment was made issuing 10,000 shares of Allstar common stock, par $1, to the seller (market value $14 per share).

---

*Sold at book value.
**Proof: Beginning cash balance, $35,000, minus the ending cash balance, $29,000, equals a $6,000 decrease.

TRAINER'S GUIDE

SESSION:	INTER-RELATIONSHIP OF BALANCE SHEET, PROFIT AND LOSS, AND FUNDS FLOW STATEMENT
Module C:	Income Statement
Group A:	Credit Officers
Total Time:	45 minutes

A. Teaching Objectives

1. To explain the meaning and importance of the income statement.

2. To provide a definition of an income statement and emphasize the need to "walk-through" the same steps that were indicated in the balance sheet module before analyzing a balance sheet.

3. To provide key definitions of components of the Income Statement (revenue/sales; cost-of goods sold; and methods of accounting for inventory and depreciation) and analyze how the components fit together in an income statement.

4. Review and Discuss the income statement and introduce a discussion of the interconnectedness of the balance sheet, income statement, and funds flow statement.

B. Suggested Teaching Techniques

Begin with an open discussion of the meaning and importance of the income statement. Refer participants to a general definition of the income statement and a sample income statement. Show transparency of income statement.

Walk through briefly the seven preliminary steps to the analysis of an income statement.

Go through the components of the Income Statement and ask the participants for comments. Emphasize the key factors in the statements, especially the methods for accounting and depreciation and the suitability of these methods.

Review the sessions main points and open up to questions and answers.

Materials:	Pencils, pads.
Exhibits:	A general definition of an income statement; an example of an income statement.
Overhead/ Visuals:	Income statement.
Equipment:	Flipchart, and magic markers.

SESSION: INTER-RELATIONSHIP OF BALANCE SHEET, PROFIT AND LOSS, AND FUNDS FLOW STATEMENT (continued)

Objectives: Understand the significance of an income statement.

Module C: Income Statement
Group A: Credit Officers

Activities: Introduction

The income statement (P&L) summarizes the revenue realized from the sale of goods or services and the expenses incurred by a company to earn this revenue.

The income statement can be regarded as a report card on management's operational capabilities.

1. Prepare for Analysis of the Income Statement

   Before conducting the evaluation of the income statement the analyst should:

   - Verify the usefulness and timeliness of the statement, how it was prepared, and when; decide whether the statement is prepared by management or by an outside reputable accountant. If prepared by an accountant, the analyst must decide whether an opinion is expressed and, if so, what type. Read the footnotes and understand the accounting principles applied; determine whether the principles are acceptable and consistent; whether the interval covered is current and relevant, and whether the information takes the operations through an entire business cycle.

   - Try to understand the industry the company is in, its products, the competition, and the company's overall position within the industry.

   - Be aware of the company's objectives in order to measure their achievement.

   - Be aware of the current and projected environment in which the company must operate.

   - Prepare the information on a spread sheet so that horizontal and vertical analysis can be done (an example of a spread sheet is shown in Module A, Balance Sheet). The figures are spread not because bankers cannot read a financial statement, but because the format is consistent and permits a quick, uniform analysis of trends, relationships, ratios, and changes. Spreading also forces the user to examine the numbers and look at the footnotes.

   - Visit the company for a first-hand inspection, if possible. The whole purpose of analysis is to "get behind the numbers," and a personal visit enables the analyst to put numbers on assets and operations.

- Understand the reason for the particular analysis. It could be for the purpose of reviewing the performance of a company with an outstanding obligation to the bank or for examining a new loan request that requires quantification of the borrower's ability to repay the loan in the future.

2. Analysis of Components of the Income Statement

- Revenues

  - Sales (how defined, credit or cash)
  - Sales mix
  - Share of market
  - Environment - domestic/foreign stability

- Cost of goods sold (definition)

  - Manufacturing (raw materials, labor, overhead)
  - Service (labor, overhead)

- Key factors to consider

  - Availability and price volatility of raw materials
  - Availability and price volatility of labor
  - Methods of accounting for inventory and depreciation and the suitability of the methods
  - The ending inventory impact on gross profits

- Operating Expenses (normal expenses of running a company not directly related to the product or service).

- Operating Profit (funds that remain after all expenses directly related to the sale of a product have been calculated, but before other income and expense items and taxes have been deducted).

- Other Income (this category consists of income items not generated through the normal operations of the company. Examples would be sale of assets, interest income, stock dividends and real estate among others).

- Other Expenses. Other expenses, as other income, fall outside of normal operating company expenses. Examples include interest, bad debt, discounts, and losses from sale of assets.

- Profit Before Tax. Deduction of other income and expenses as well as federal, state and, where applicable, local taxes must be dealt with before net profits can be distributed.

- Income Taxes

- Net Profit After Taxes

TEACHING AIDS

EXHIBIT 1

The Income Statement (or the profit and loss statement, the statement of earnings, or operating statement)

It is an accounting report that summarizes the revenues and the expenses of an accounting period. Technically it is subordinate to the balance sheet because it shows in some detail the items that collectively account for most of the period's net change in only one balance sheet item, retained earnings.

However the information on the income statement is regarded by many to be more important than the balance sheet information. This is because the income statement reports the results of operations and indicates reasons for the entity's profitability (or lack thereof). The profit and loss statement is important because in situations where accountants must choose between a procedure that distorts the balance sheet or one that distorts the income statement in recording an event, they usually choose not to distort the income statement. The heading of the income statement must show: (1) the entity to which it relates; (2) the name of the income statement; and (3) the time period covered. The SEC requires that corporate annual reports contain income statements for the most recent three years and balance sheets as of the end of the two most recent years.

The income statement should end with the item "earnings per share." This final section links the period's income statement to the beginning-of-the-period and end-of-the-period balance sheets by completing the explanation of the net change in retained earnings between these two balance sheet "snap-shots." This calculation is called a statement of retained earnings or sometimes a reconciliation of retained earnings.

EXHIBIT 2
INCOME STATEMENT
January 1st to December 31st., 1956, Inclusive

Operating Revenue:

Interest and other fees on loans	$270,000
Interest and dividends on securities:	
U.S. government obligations	44,000
Obligations of states and political subdivisions	35,000
Other securities	1,500
Trust department income	15,500
Service charges on deposit accounts	19,200
Other operating revenue	4,800
Total operating revenue	$390,000

Operating Expenses:

Salaries	$ 97,900
Bonuses and profit sharing	10,100
Pension, social security, other employee benefits	12,000
Interest on deposits	96,800
Inteest on borrowed money	4,100
Net occupancy expense of bank premises	24,000
Equipment expenses (including depreciation of $1,200)	12,400
Other operating expenses	16,000
Total operating expenses	$273,300
Operating earnings before income taxes	$116,700
Income taxes applicable to operating earnings	34,700
Net operating earnings	$ 82,000

TRAINER'S GUIDE

SESSION:	INTER-RELATIONSHIP OF BALANCE SHEET, PROFIT AND LOSS, AND FUNDS FLOW STATEMENT
Module D:	Relationship to Modules A, B, C
Group A:	Credit Officers
Total Time:	30 minutes

A. Teaching Objectives

1. To review the definitions and examples of a Balance Sheet, Profit and Loss, and Funds Flow Statement.

2. To reinforce (graphically) the relationship between the three financial statements.

3. To emphasize the key elements in each statement and interpret their significance.

4. To review the interrelationship between the Balance Sheet, Profit and Loss, and Funds Flow Statement, and to provide a conclusion to the entire module.

Suggested Teaching Techniques

Begin with a review of the Basic definitions of the three financial statements. Ask the participants to give a definition and list them on the blackboard or on a flipchart.

Go through several key components of the three statements such as the working capital ratio, the Return on owner's investment, the ratio of proprietorship to total assets, and the debt/equity ratio for the balance sheet; sales; cost of goods sold, and gross profit/net profit for the interpretation of the Profit and Loss statement; and several sources and uses of funds. (Use the flipchart to write them down.) Give an interpretation of these components and show how they impact on the interrelationship of the statements.

Review the definitions and interrelationship of the three financial statements, open up to questions and answers, and conclude the module. Refer to short definitions of balance sheet, income statement, and funds flow statement showing articulation between them.

Materials:	Pencils, pads.
Exhibits:	A short, written conclusion on the interrelationship of the three financial statements. A chart showing the interrelationship of the statements. Examples of balance sheet, statement of changes in financial positions.
Overhead/ Visuals:	Use the transparency showing the relationship among the financial statements.
Equipment:	Projector; screen; flipchart and magic marker.

SESSION: INTER-RELATIONSHIP OF BALANCE SHEET, PROFIT AND LOSS, AND FUNDS FLOW STATEMENT (continued)

Objectives: To review relationship of financial statements.

Module D: Relationship to Modules A, B, C
Group A: Credit Officers

Activities: Introduction

The sister statement to the income statement is the balance sheet. The analyst must have both in order to see a complete picture of the business being studied. Unlike the income statement, which is a reflection of performance over a period of time, usually a month, quarter or year, the balance statement, or statement of financial position, is a statement of assets, liabilities and owner's equity levels at a particular time. The two statements are related, as the balance sheet reflects levels of various categories for the same day that the period for the income statement ends.

The funds flow statement illustrates the decisions (balance sheet) and results (income or P&L statement) affecting the operations of a business.

1. Balance Sheet, P&L and Funds Flow Statement

   - Interpretation of Balance Sheet

     - Current assets to current liabilities
     - Ratio of proprietorship to total assets
     - Ratio of fixed assets to fixed liabilities

   - Interpretation of P&L Statement

     - Sales
     - Cost of goods sold
     - Gross profit/net profit

   - Interpretation of Funds Statement

2. Conclusion on Interrelationship between Balance Sheet, P&L and Funds Flow Statement

TEACHING AIDS

EXHIBIT 1
SUMMARY OF STATEMENTS

The balance sheet and income statement (statement of operations) are said to correspond, that is, there is a definite relationship between them. The amount of net income reported on the income statement, together with the amount of dividends, explains the change in retained earnings between the two balance sheets prepared as of the beginning and end of the accounting period. The income statement and related statement of retained earning, a flow report, reconcile the retained earnings amounts from the beginning and ending balance sheets, which are status reports.

Some comments on the Funds Flow Statement (Statement of Cash Flows or Cash Flow statement).

The purpose of the Funds Flow Statement is to provide information about the cash flows associated with the period's operations and also about the entity's investing and financing activities during the period. This information is important to shareholders, part of whose investment return (dividends) is dependent on cash flows, to lenders, whose interest payments and principal payments require the use of cash. In 1971, the American Accounting Principles Board called the Funds Flow Statement the (SCFP) Statement of Charges in Financial Position. In 1988, this was charged to the Statement of Cash Flows.

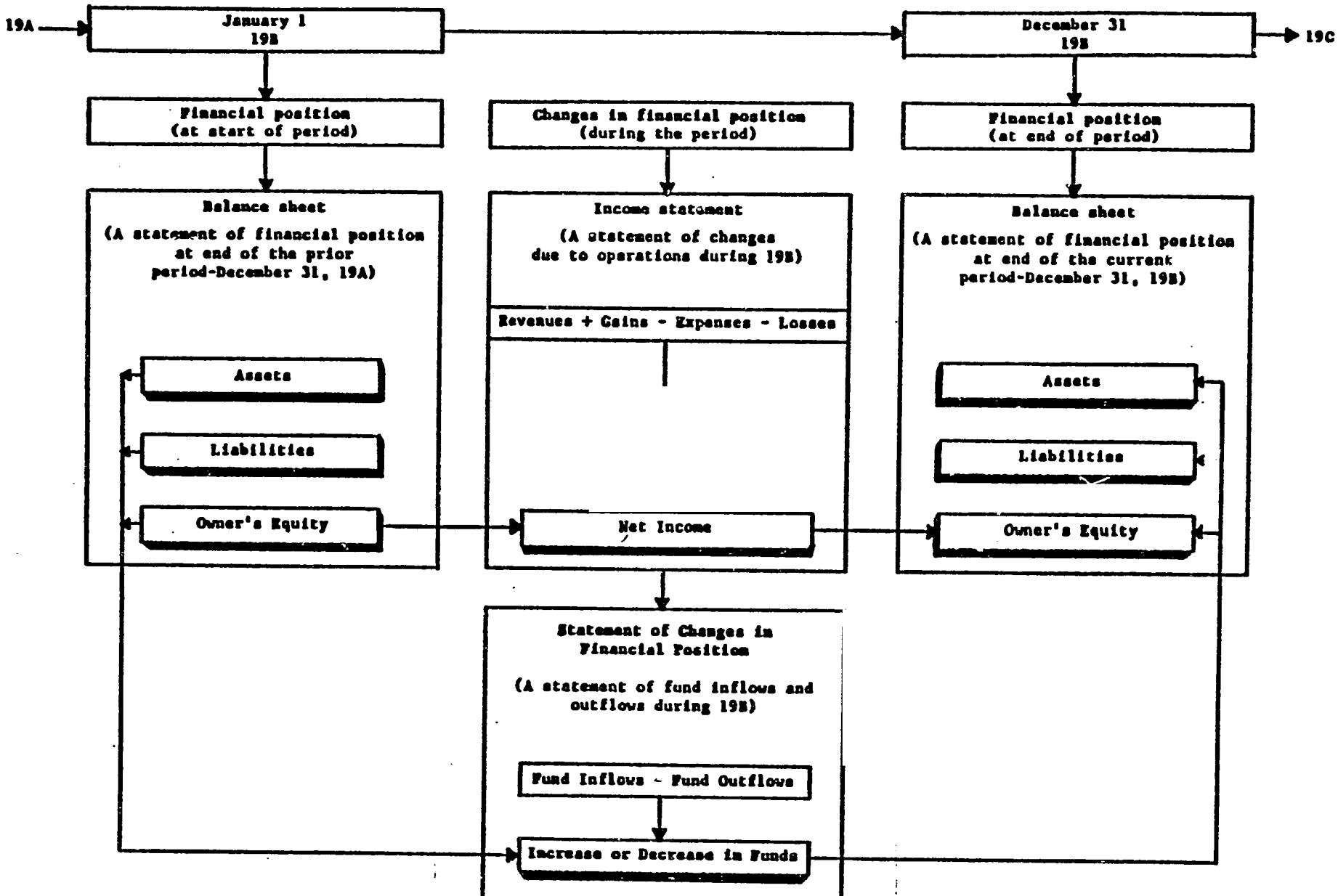
Activities That Generate Cash (Sources)
("where got")

1. Operations
2. New borrowings
3. New stock issues
4. Sale of property, plant, equ
5. Sale of other noncurrent ass

Activities That Involve Spending
("uses" or "where gone")

1. Cash dividends
2. Repayment of borrowings
3. Repurchase of stock
4. Purchase of property, plant, and equipment
5. Purchase of other noncurrent assets

EXHIBIT 2
RELATIONSHIPS AMONG FINANCIAL STATEMENTS



Welsch, G.A.; Newman, D.P.; Zlatkovich, C.T.; Intermediate Accounting (1986, Seventh Edition Irwin), p.146.

TRAINER'S GUIDE

SESSION:	LIFE CYCLE OF A SMALL BUSINESS
Group B:	Entrepreneurs
Total Time:	3 hours

A. Teaching Objectives

1. Enable participants to understand the requirements and decisions necessary to starting and maintaining a small business and how it affects access to credit.

2. Provide participants with information on the characteristics of effective entrepreneurs as a basis for self-assessment and planning.

B. Suggested Teaching Techniques

Review the basic requirements to starting a successful small business. Discuss the pros and cons of business ownership.

Provide participants with the Small Business Planning Checklist. Have each participant review the checklist. Discuss the major elements in the checklist, and the experiences/perceptions of the participants regarding specific items.

Working individually and/or in small groups have the participants complete the worksheet with special attention to facility requirements, cost information, volume, and various cost factors.

Review and summarize the key learning points. Ask participants to highlight those items in the checklist that appear to be most critical. Also discuss conditions in which a "no go" decision is advised in terms of starting a new business. Review/discuss checklist.

Materials:	Pencils, flipchart and markers.
Exhibits:	Pie graphic.
Overhead/ Visuals	Graphic on characteristics of entrepreneur.
Equipment:	Projector.

SESSION: LIFE CYCLE OF A SMALL BUSINESS

Objectives: **To understand the requirements and decisions necessary to starting a new small business and how it affects credit access.**

Module A: Business Planning Checklist
Group B: Entrepreneurs

Activities: Introduction

A small business is usually considered one with few employees and assets, rather than low sales volume and not much capital.

The owner is usually directly involved in the management as well as the operations of the business and may not have had much training, or experience in accounting, taxes, finance, or business practices and procedures.

1. Basic Requirements to Start a Successful Small Business

It is important to realize that to start a new business of any type is to be exposed to a risk of business failure; to start a small business is to increase the exposure; to start a small business without enough financial support further increases the risk; and to start such a business without enough advance planning and without seeking the information necessary to run the business is to increase the risk of failure almost to the point of certainty.

According to The 1983 Dun & Bradstreet Business Failure Record, there were 31,334 business failures in the United States, of which approximately 50 percent were small businesses. The same source stated: "Underlying causes of business failures include incompetence, lack of well-rounded business knowledge, and lack of experience in a particular industry."

The type of small business most likely to succeed is one that is -

- Based on a product or service that can be
- Obtained in necessary volume at a low enough cost, so that after adding a profit, it can be
- Sold at a competitive price to
- Buyers who will pay for it, and in total, who will buy enough so that a volume sufficient to make a continual profit will be reached

What follows is intended to aid you in determining if your idea is a sound one on which to build a small business and, if you decide that it is, to point out other considerations you must face.

2. Small Business Planning Checklist

- Before actually starting a small business, you should prepare a checklist of items to be covered in planning. While you are trying to decide, the list may be increased as new items come up. Such a list should -

  - Provide direction to the planning effort to keep it orderly and logical.

  - Serve as a record of items considered, rejected, and approved, in order to avoid redoing something already done.

  - Provide target dates for action.

  - Serve as a record of the extent of planning.

  Specific items on the checklist may include, but are not limited, to the following:

  - Definition of the proposed product or service
  - Facilities required
  - Cost estimates
  - Sales forecast
  - Cash flow
  - Financing
  - Organization

  Most of the above items are so closely related that one depends on another.

  What follows in this section deals with starting a new business. But most of it, if not all, also applies if an existing business is to be bought from someone. The only real difference is that it may be easier to get some of the information from the present owner, if it is available and can be relied on. This section also presupposes that the business will make and sell a product. Though some of it would not be necessary for a business that buys and sells a product or sells a service, the general guide to getting information for decision-making would still apply.

3. Proposed Products or Services

- Definition

The first step in starting a new business must be to have a clear idea of the products or services upon which your business will be built. You must be able to describe, first to yourself and later to others, what you plan to do.

Write, in everyday, nontechnical words, a simple definition of the goods or services that will be the source of income to your business. Be as specific as you can. Include in your definition a brief description of your potential customers and area and method of sales.

Your first attempt to prepare an adequate definition will be difficult and probably incomplete. Keep working on it until you are satisfied. Then get someone to read it to determine if it is clear to others.

As your planning progresses, your first ideas of the products or services you will offer may change; if so, rewrite your definition. Remember, this will be the basis of all the other planning steps, and later, the source of your income. Be sure you know your products or services and can clearly describe them to others.

- Qualifications

Having developed a sound written description of the products or services to be sold by your business, you must next make a careful analysis of your ability to handle the product or service. Is it something with which you have had experience or training, or do you expect to "learn as you go"?

Make as complete a list as you can of all the skills required to get your product or service to the customer. Opposite each item on the list indicate your abilities for those you plan to handle yourself, or the source of help if you expect others to handle the item. You may have open tasks. Put these on your checklist (Sec. 1, page 5).

Does your idea for starting a business still look good to you?

- Restrictions

When you are satisfied that all necessary tasks involved in your proposed business can be handled, you must make sure that there are no government or business restrictions that would stop you from being in that particular business. Are there local, state, or federal laws prohibiting or regulating the business? Are there any qualifying licenses required? Are there any patents, copyrights, or business franchise restrictions?

If you are not certain about answers to these questions, put them on your checklist.

- Economics

Without being concerned at this point in your planning about the profit possibility of your business idea, examine your source of sales. Is yours a seasonal or a year-round item? Is it a one-time or a frequently needed purchase? Is it a new item for which a demand must be created, or is the demand already there? How is the demand now being met - by the same item or by another item? How does your item compare with the existing one? How will you sell your item - through existing outlets, by mail, or by your own sales group or outlet? Does your item require after-sale service? What type of competition will you face? Who will be your suppliers? What is the normal method of payment for your type of item?

In asking yourself these questions, you are also asking if your idea still looks good to you.

4. Facility Requirements

- Work Sheet

Your next step should be to prepare a detailed work sheet describing the facilities required. Facilities include all the equipment, furniture, fixtures, tools, space, and so forth that you will need to run your business. These items will make up the fixed costs of your business and, as such, should be carefully controlled. An example is shown of the type of work sheet that will be helpful in making a record of your requirements and in estimating the related costs.

You can see that the suggested work sheet is set up to provide space for the following requirements: Use of Facility, Description of Facility, Estimated Cost of Facility, Monthly Cost, Record of Action Taken to Obtain the Facility.

You may be able to get all your requirements on one work sheet or it may take many.

5. Review Work Sheet (Sample)

Facility Requirement Work Sheet

Use of Facility	Description of Facility	Monthly Cost of Facility	Record of Action

Most Desirable — Next Most Desirable — Least Desirable

6. Estimating Costs

- **General Information on Costs**

The following is intended to help you understand and prepare cost estimates for a small business selling products or services that are similar in the way they are prepared for the market. More involved procedures would be needed for widely different items produced in a single business. Do not hesitate to get outside help in preparing and reviewing your estimates.

The cost of operating your proposed business is made up of various parts, depending on the type of business. In general, these will include the following costs.

- **Fixed costs**. These are the costs that are about the same from the day you start in business. Rent, light, power, and depreciation are types of fixed costs. Your salary may also be included here. Fixed costs are the same regardless of the amount of your sales or production.

- **Direct costs**. These are costs that go up or down with increases or decreases in your sales and production. The product you buy to resell to your customer or the material and labor of making the product yourself are direct costs. Direct cost may be material cost if it originates with a purchase you make, or it may be labor cost if it is your payroll. All direct costs can be related to a particular product or service.

- **Indirect costs**. These costs may vary from period-to-period but not necessarily in the same proportion as your sales or production. They are for those goods and services necessary for your business but not related to particular items that you sell.

- **Volume**

From that oversimplified explanation of cost factors you can determine that the cost of your product or service, at the point in time it is ready to be sold, includes the direct cost of the material and labor going into it plus some portion of the fixed and indirect costs. The amount of fixed and indirect cost that each product or service must carry depends on the number or volume of items produced and sold.

At the end of any given period the volume is known and the actual cost can be determined. However, you cannot wait until the end of a period to determine your costs and the related selling prices. Therefore, it is necessary to estimate the volume before you can estimate the cost.

Your estimate of volume must represent a realistic balance between your ability to produce goods or services and your ability to sell them. In most cases the amount of fixed and indirect costs to be added to the direct cost of an item can be best stated as a percentage of the direct cost.

For example, if your estimated monthly volume is 500 units at an average direct cost of $20 each, and estimated monthly fixed costs are $1,000 with estimated indirect costs of $500, the overhead rate and unit costs would be as shown below.

- Other Costs

In addition to the costs described above, you will probably have selling costs and general and administrative costs. The selling costs will include sales salaries, commissions, advertising, and similar items related to your sales efforts.

General and administrative costs include office salaries and supplies, interest, taxes, and similar items. Both sales and general and administrative costs are added to each item as a percentage in the same manner as described for fixed and indirect costs.

- Estimating Your Fixed Cost

Because of the relationship of your fixed cost to your cash flow and financing (discussed later in this section), it will be necessary for you to make some assumptions that may later have to be changed. However, it is better to estimate your cost on the high side than estimate too low, so you should use the Most Desirable cost figures shown on your facility work sheet to estimate fixed cost.

In setting up your facility work sheet, you have grouped the various items by the use or function they serve. By so doing, you have divided your facilities into production, sales, and office use.

Write the monthly cost after each item on the work sheet. For items that are rented or for which you will receive monthly bills, you already know the monthly cost. For items you will buy, the monthly cost is determined by dividing the amount you expect to pay for an item by the number of months you expect to use it.

The total of the monthly costs for each item within a use group will give you the estimate of the fixed costs for that group.

- **Estimating Your Direct Costs**

  Remember that direct costs are made up of the material and labor costs that go into the item you will sell, whether you deal in products or in services.

  To estimate your direct costs, you must make a list of all the materials going into the item (this list is called a bill of materials) and a list of each task of labor required to complete the item (called an operations sheet). Your ability to prepare the necessary bills of material and operations sheets is a good test of your qualifications for your proposed business.

  Estimate the cost of the materials and of the labor operations. Be sure to include the necessary scrap or waste in the materials and any freight or handling costs related to the materials. Labor costs should be estimated on the basis of the time required for the operations multiplied by the rate you will pay for labor. The time factor should include a normal amount of lost time. The labor rate should include the taxes and any fringe benefits for which you expect to pay.

- **Estimating Your Other Costs**

  The indirect costs, sales costs, and general and administrative costs may each contain fixed costs (from your facility work sheet), material costs (mainly supplies), labor costs, and certain other costs such as interest expense.

  Prepare a sheet for each type (indirect, sales, general and administrative) in the same manner you did for direct cost.

- **Summarizing Your Cost Estimates**

  - Review work sheet
  - Prepare sample

- **Estimating Your Selling Prices**

  - Review costs versus prices
  - Decisions affecting prices

6. Sales Forecasts

- **Based on Volume and Prices**

  - Estimate cash needs
  - Cash shortage - failure of a business

7. Preparing Projected Cash Flow

- Source of Cash Flow Data
- <u>Preparing Cash Flow Projection</u>
  - Cash on hand
  - Cash received
  - Cash paid out (see item list)
- Determination of capital required

8. Providing Financing

- <u>Sources of Financing</u>
  - Banks
  - Credit unions
  - Financial institutions
  - Personal sources - friends/family

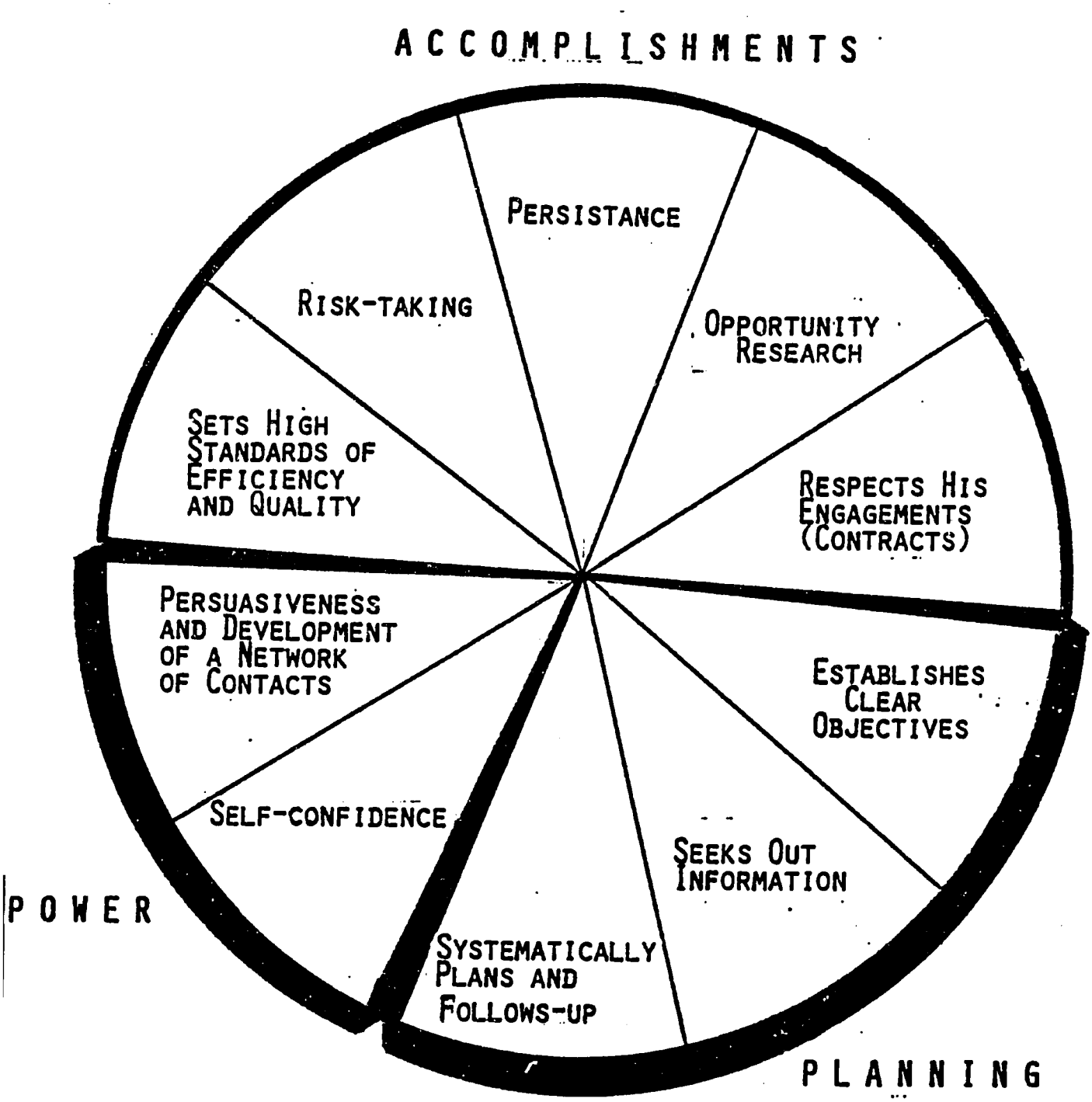
9. The Business Organization

- Legal form
- Name
- Requirements (e.g., licenses, permits)
- Insurance
- Advertising
- Services (accounting, legal, marketing)
- Employees (mix, number, delegation)

TEACHING AIDS

EXHIBIT 1

THE PERSONAL CHARACTERISTICS OF A TRUE, PERFORMING ENTREPRENEUR



SESSION: LIFE CYCLE OF A SMALL BUSINESS (continued)

Objectives: To review and understand basic accounting and need for business records

Module B: Business Records
Group B: Entrepreneurs

Activities: Introduction

The purpose of this section is to help the owner of a business keep accounting records necessary to run the business. Some of the records and accounts needed will be different for different kinds of business. The lack of proper records or an inability to understand existing ones is a frequent cause of business failure. One key to good business management is good accounting records.

- Accounting records - concerned with all aspects of business.
- Purpose - for accurate information on wages, sales, prices, profits, etc.
- Maintaining good accounting records. A formal process.

1. Cash Sales (full price; receipts)

   When the full price is received at the time of sale, it is known as a cash sale.

   At the time of a cash sale, a record must be made for the cash received. This record may be a form of receipt or may be rung up on a cash register. The receipt or cash register tape should show the date of the sale, the amount received, and the sales tax on the sale. See the section "Cash Drawer or Cash Register" for what needs to be done at the end of each day.

2. Sales on Credit

   When the full price is not received at the time of sale, it is known as a charge sale or a sale on credit.

   Such sales bring about an account receivable to be collected at a later time. The sales on credit must be kept separate from cash sales. A charge-sales slip must be made out even if a cash register is used. The sales slip in this case will serve as support for the difference between the cash taken in and total sales on the cash register tape.

The charge-sales slip should show the following information:

- A preprinted serial number
- The terms of the sale
- The date of the sale
- The name and address of the customer
- The number and the description of each item
- The unit price of each item
- The total amount of the sale
- The amount of cash received at the time of the sale
- A signature of the person who received the merchandise
- A signature of the person who sold the goods

The charge-sales slips are the accounts receivable that are created when a customer purchases an item but doesn't pay cash for it. (Sales slips can be designed so that the same form can be used for both charge and cash sales as in the samples shown.)

At the end of each day the charge sales should be totaled and posted to the customer accounts receivable ledger. The charge-sales tickets should be filed according to the customer's name as a record of what each customer owes.

3. Sales Returns and Allowances

You may agree to take back goods which were sold to a customer, or you may reduce the price at which a sale was made because of a customer's complaint. Sales returns and allowances are decreases in sales.

If it was a cash sale, pay the customer the amount in cash and make out a cash-sales slip, clearly marking it "refund" or "allowance" to correctly account for the reduction in cash. If it was a charge sale, make out a charge-sales slip, again clearly marking it "credit" to show that the customer owes that much less.

4. Sales Journal

The non-cash sales should be posted to a sales journal. The sales journal is a summary of sales sold on credit. The sales journal may be prepared at the same time as the non-cash sales slip and the accounts receivable ledger, or it may be prepared separately.

5. Cash Receipts

Cash usually comes from three sources:

1. Cash sales to customers
2. Cash received on account for sales previously made on credit
3. Miscellaneous sources

Each time one of these sources of cash is received, a written record must be made. If it is a cash sale, the record may be a cash register tape. If not, the record may be in the form of a receipt. The receipt for cash should be prepared in at least two copies, with the original going to the person making the payment and the other copy being kept for recording the acceptance of cash.

When cash is received on account, the receipt should show the customer's name, and so forth, and be posted as a credit to the customer accounts receivable ledger.

Miscellaneous cash receipts should show the source, amount, and nature of the cash received. Cash receipts should be summarized in a cash receipts journal.

6. Cash Discounts on Sales

When merchandise is bought on credit, the buyer is expected to pay the seller within the agreed-on time. To encourage the buyer to make payment before the end of the credit period, the seller may allow a deduction from the amount owed. A deduction that the seller allows on the amount of an invoice to encourage the purchaser to make prompt payment is known as a cash discount.

When the customer takes advantage of a cash discount, the seller receives a sum less than the sales price recorded on his books. This cash discount is a deduction from sales and is debited on the books of the seller to an account with the title of Sales Discounts.

7. Cash Receipts Journal

The cash receipts journal is a summary of cash received showing the source from which the cash came.

The cash receipts journal should have the following columns or information:

- Date of receipt of the cash
- Source from which received
- Total amount received
- A column for the amount from cash sales
- A column for the amount received on account
- A column for miscellaneous cash receipts stating the nature of the receipt

8. Accounts Receivable

The charge-sales tickets should be posted to a sales journal and accounts receivable ledger. The accounts receivable ledger should show the following information:

- The date of the sale
- The number of the sales slip
- The amount of sale
- The name and address of the customer (on the top of each ledger card)
- A credit column to record the cash received or other reductions in the account
- A balance column representing the amount that the customer owes

9. Cash Drawer or Register and Closing

You should always keep track of how much cash you start with each day. It would be good if you started daily with the sam amount, but always count the cash before opening.

At the end of the day, count the cash on hand. Separate the different tickets and count these items. If you are using a cash register having several keys, the tape for that day may show separate totals for each type of ticket - charge sales, cash sales, etc. To balance with the tape of the cash register, it is important that all transactions are recorded on the cash register and all the tickets are filled out properly. After arriving at the correct balance (see illustration), write the totals for cash collected, non-cash sales, sales discounts, and sales returns in the sales and cash receipts journals. Do this every day to maintain a record of each days' transactions.

Balancing and summarizing the day's transactions may be done as follows:

(1) Total cash in drawer or register		$4,801.50
(2) Cash sales		$1,078.50
(3) Collections on accounts receivable	$3,700.50	
(4) Less - cash discounts allowed	98.50	3,602.00
(5) Cash sales of scrap		21.00
(6) Amount to be deposited		$4,701.50
(7) Working cash fund (1-6)		$ 100.00
(8) Cash sales (as above)		$1,078.50
(9) Charge sales		5,781.50
(10) Total sales (8 + 9)		$6,860.00
(11) Returned merchandise		$ 90.00

Keep a file for each set of tickets, and at the end of the day put that day's tickets in their respective file. It is important that all cash totals and related slips agree with the cash on hand. The non-cash sales tickets are very important since you want to keep a record of who owes money (accounts receivable).

10. Recording the Buying of Merchandise on Account

Goods carried in stock for sale to customers are known as merchandise. Merchandise may be purchased from a salesperson, a wholesaler, manufacturer, or from a catalog. When merchandise is purchased, prepare a form known as a purchase order. The purchase order should be prepared in more than one copy. The purchase order should show from whom the merchandise is being purchased, the date ordered, the method of shipment, th terms of payment, the quantity ordered, a description of the item, the cost of each item, total cost of all items ordered, desired date of receipt of the merchandise, and the name and signature of the person ordering the merchandise.

The original copy of the purchase order should be given to the person from whom the merchandise is being purchased. You should maintain a duplicate copy or copies to be used as a record of merchandise on order and to check the merchandise when received.

When the merchandise is received, or soon after, you should get a bill or invoice requesting payment. These invoices vary from business to business, but most invoices include the following:

- The name and address of the one from whom the merchandise was purchased
- The name and address of the purchaser
- The date of the invoice
- The seller's invoice number
- The method of shipment
- The terms of payment
- The buyer's purchase order number
- The quantity, description, and unit price of items purchased
- The total cost of each item and the total of the invoice

When you receive this invoice it is important to confirm that the items ordered have been received and that the proper amount has been charged. You should, therefore, perform the following:

- Compare the invoice with the purchase order to see that the items on the invoice agree with those on the purchase order.

- Examine the receiving report to see if all items were delivered.

- Check the invoice to see that quantities and prices are in agreement with the purchase order.

- Verify the computation of the sales tax and discount, if applicable.

- After steps one through five above have been completed, approve the invoice for payment in writing on the face of the invoice.

At this point the invoice may be paid or entered in the purchase journal. A purchase journal is necessary when items are not paid promptly or are numerous.

11. Purchase Returns and Allowances

The buyer of merchandise may be allowed credit by the seller for the return of part or all of the merchandise purchased. He may also be allowed credit if the merchandise received was not up to quality or was damaged.

The buyer usually receives a credit memorandum from the seller showing the amount of the purchase returned or the purchase allowance. The credit memorandum should be applied against any amounts owed the vendor or a refund should be requested. The purchase order form properly marked "returned goods" may be used as a record to be sure credit is received.

12. Purchase Journal

If invoices are not paid promptly or are numerous, they should be recorded in a purchase journal or schedule of unpaid invoices.

The purchase journal should include the following columns:

- The date the invoice was received
- The invoice number
- The name of the firm from whom the purchase was made
- The date paid (to be completed when paid)
- The check number of which it was paid (to be completed when paid)
- The amount of the invoice
- The account or account number to which the expense is to be charged, or a column for each major expense account with a miscellaneous column for those account used infrequently.

13. Cash Disbursements

All bills, purchases, expenses, etc., should be paid by check. No check should be written until there is proof that the service or merchandise has been received and is satisfactory. When a check is written, the purpose for payment should be stated on the check and the check stub. The bill, invoice, or proof that the service or merchandise

has been received should be clearly marked "paid," dated, and the check number listed to prevent duplicate payment. The paid bill should then be filed in a "paid" file in alphabetical order for future reference. After the check has been written, it should be recorded in a cash disbursements journal for the purpose of summarizing the various types of expenses paid.

14. Cash Discount on Purchases

To encourage the buyer to make payment for merchandise before the end of an agreed-upon credit period, a seller may allow a deduction from the amount owed. When the buyer takes advantage of this discount, the payment is less than the purchase price recorded on your books in Accounts Payable. The cash discount is a deduction from purchases and is credited on the books to an account with the title of Discount on Purchases.

15. Cash Withdrawals by Owner

A person who is the sole owner of a business often withdraws cash from the business as needed for personal use. This represents a withdrawal of an asset from the business. Withdrawals by the proprietor are not deductible expenses for federal income tax purposes. Because of this, withdrawals of cash or other assets by the proprietor are not charged to an expense account. They should be charged to an account known as a drawing account.

16. Petty Cash Fund

Good business practice requires that two rules be closely followed when dealing with cash:

1. All cash receipts must be deposited in the bank each day and not be used to pay expenses.

2. All expenses should be paid by check.

Every business, however, has many small bills that are more easily paid by cash. It is just not practical, for example, to pay messengers or buy postage stamps with checks. These cash payments, which are exceptions to rule two, require that a special cash fund be used for small expenses. This type of fund is called a petty cash fund.

To create such a fund:

- Estimate the amount of small expenses that will be paid in cash during an average two-week to one-month period.

- Cash a business check for this amount and keep all the money in a separate place, controlled by only one person. This fund should remain at that fixed amount and not change from one period to another.

- Each time an expense is paid out of this fund a bill marked "paid" or a signed receipt for the amount paid should be kept with the money so that at all times the total of bills or receipts and the money still in the fund will equal the fixed amount of the petty cash fund.

- Remove all paid bills and signed receipts when the fund becomes low, and write a business check for the total of these items. When this check is cashed, it replaces the money used and brings the balance of cash in the fund to the original fixed amount. When the fund is reimbursed, the various expense accounts should be charged for the amounts spent.

17. Cash Disbursements Journal

The cash disbursements journal should show the following information:

- Check number
- To whom written
- Date written
- Gross amount
- Discount taken
- Net amount
- A distribution to the expense or account affected

18. Time Card or Time Sheet

Each employee of the business should prepare a time care or time sheet that covers a specific pay period such as one week, two weeks, etc. At the end of this period of time, the following steps should be performed.

1. The time cards are examined for records of tardiness, leaving early, absence, etc.

2. The regular hours are extended into the Hours column.

3. The amount of overtime for each day is figured and entered on the time record.

4. The regular hours and overtime hours are totaled separately.

5. The rates for regular and overtime are entered, and the earnings are computed.

6. The hours and earnings for regular and overtime are then added to show total hours and total earnings.

7. The different deductions are figured and then the net amount to be paid is determined.

After completion of these steps, the next records to be prepared are the payroll checks, payroll register or payroll journal, and the employee earnings records.

19. Payroll Register or Payroll Journal

After completing the time cards, the payroll journal should be completed using the information from the time cards. Simple forms are available with which you can write in the payroll check and record amounts in the payroll journal and the employee earnings records all at the same time. These forms save the time of writing the same information more than once.

The total earnings figure from each time card is entered in the Total Earnings column of the payroll journal opposite the name of the employee. The section headed Deductions is used to enter the amounts that are deducted from the employees' earnings. The column headed FICA Tax is used for Social Security. The Social Security tax can be computed by formula or obtained from a government table.

The column headed Federal Income Tax is used for the federal income tax withheld from each employee's earnings. This can also be obtained from a government table. This same thing would be done for state and city income taxes. The column headed Other is used to enter such items as deductions for purchase of savings bonds, union dues, and so forth. The space headed Net Pay is used to record the amount due each employee.

After the entries for all employees have been made, each of the amount columns is totaled. To check these additions compare the total of the Total Earnings column with the sum of the totals of the Net Pay column and the Deductions columns.

20. Employee Earnings Record

A detailed account is kept for the payments made to each employee. This record, known as the employee earnings record, is kept on cards or sheets. A separate card or sheet is kept for each employee. This record is made with divisions for totals every three months because the federal, state, and some city governments require reports on a quarterly basis.

The amount columns of the employee earnings record are the same as the amount columns of the payroll journal. The quarterly totals line provides space for the totals for the quarter, and the final quarter provides space for entering the totals for the year. The yearly totals are needed for preparation of annual reports to the federal, state, and some city governments.

21. Payroll Check

All payments to employees for work done should be by check. It is helpful to use a different type of check for payroll than that for general disbursements. If, however, the same type of check is used for both payroll and general

disbursements, additional information should be entered on the check stub. This information should include total earnings, payroll deductions, and so forth.

The amount of the payroll check should be the same as the Net Pay column of the payroll journal and employee earnings record.

22. Journals

A book of which any of the records of a business are first written is called a journal. There are many kinds of journals. The basic types are as follows:

- General journal
- Sales journal
- Purchase journal
- Cash receipts journal
- Cash disbursements journal
- Payroll journal

Every journal has two parts - the debit part and the credit part. For example, the general journal usually has two amount columns: the left-hand amount column is called the debit column; the right-hand amount column is called the credit column.

The general journal is used to record openings, closings, corrections, and unusual entries that cannot be recorded in the special types of journals.

23. General Ledger

As business is transacted, there will be changes in the asset, liability, and proprietorship accounts. Entries will have to be made in the various journals to record these changes.

The entries in these various journals do not bring together in one place all the information about one item, such as cash, accounts receivable, and so forth. For this reason, th items from the various journals are sorted into forms known as accounts. An account is a device for grouping and summarizing the entries in the various journals.

A group of these accounts is known as a general ledger. The general ledger may be a bound book or a loose-leaf book. It may also be a group of ledger sheets or cards filed in a tray or cabinet.

The difference between the debits (left side) and credits (right side) of a general ledger account is known as the account balance. If an account contains only one entry, this single amount is the account balance. If it contains entries on both sides, the difference between the totals of each side is the account balance.

The balance of each liability, income, and proprietor's capital account is usually a credit balance. The balance of each asset and expense account is usually a debit balance. Assets are anything owned by the business, and liabilities are amounts due to others. The difference between them is known as the owner's capital. Income amounts are used to indicate what the business charges others, such as sales, purchase discounts, interest received, and so forth. Expense accounts show what others charge the business, such as purchases, wages, rent, and so forth. See page 61 for a sample general ledger form.

24. Trial Balance

Bookkeeping records are valuable only to the extent that they are accurate. Bookkeepers should be careful to avoid errors, and they should use methods which will help them detect errors. One method of detecting or checking for errors which occur is the use of a trial balance. See page 75 for a sample trial balance form.

The trial balance is composed of three columns: account title, debit, and credit columns. Each account balance in the general ledger is entered in the appropriate column of the trial balance. After all balances have been entered, the sum of the debits should equal the sum of the credits. If they do not, proceed as follows (if the error has not been found in the first step, continue on to the next steps until it is located):

1. Add the debit and credit columns of the trial balance again.

2. Find the difference between the sum of the debits and credits on the trial balance and look in the ledger and the journals for that amount. The amount may have been omitted from the trial balance or an amount from a journal may not have been posted to the ledger.

3. Divide the difference between the sum of the debits and credits on the trial balance by two. Look in the ledger for that amount to see if it has been posted in the wrong column. A $100 debit posted in error as a credit, for example, would result in a $200 difference.

4. Divide the difference between the sum of the debits and credits of the trial balance by nine. If the difference can be divided evenly by nine, figures in an amount posted to the general ledger may have been switched (transposed); for example, $92 may have been posted in error as $29. This would result in a difference of $63 (which can be evenly divided by nine).

5. Trace the balances on the trial balance back to the ledger account to locate an error made in copying the amount on the trial balance.

6. Check the adding and subtracting done to arrive at the ledger account balances.

7. Trace the postings of each journal to the general ledger accounts by checking off each posting. You may find that an item was posted twice, not posted at all, posted incorrectly, or entered in the wrong column, that is, a debit posted as a credit.

8. Examine the journal and the ledger account to see that each item is checked twice or checked at all. All postings have not been retraced and the error should have been located.

9. If the error was not located, "refoot" and "crossfoot" each journal. To refoot is to add each column again. To crossfoot is to see that the totals of all the columns of the journal balance correctly. (For example, check to see that in the payroll journal, the Gross Pay column equals the sum of the Net Pay column plus all the deduction columns.)

25. Chart of Accounts

Every business transaction affects one or more accounts of the general ledger that was described in Section 2. In identifying the accounts involved, the use of a numbering system can save time and help in avoiding possible error. Such a numbering system is called a chart of accounts. A block of numbers is assigned to each type of account and numbers within that block are used for all the accounts of that type. This can be seen in the sample chart which follows.

The span of numbers assigned should be big enough so that as new accounts are needed, they can be given numbers within the proper group. Some businesses will have need for accounts that others will not use. A retail business, for example, will not use accounts for various material, labor, and expenses that would be used by a business that makes a product. In each instance the accounts should be designed to best serve the individual case.

SESSION: LIFE CYCLE OF A SMALL BUSINESS (continued)

Objective: To provide participants with information on local taxes and tax liabilities

Module C: Business Taxes
Group B: Entrepreneurs
Country:

Activities: Introduction

1. Types of Business Taxes

   - Payroll (if applicable)

     - Social security
     - Unemployment (federal)
     - Unemployment (state)
     - Withholding

   - Sales tax (if applicable)

   - Property tax (if applicable)

   - Income tax (if applicable)

TRAINER'S GUIDE

SESSION:	FINANCIAL PITFALLS AND DANGER SIGNALS FOR SMALL BUSINESSES
Group B:	Entrepreneurs
Total Time:	3 hours

A. Teaching Objectives

1. Enable participants to recognize conditions and events that may represent serious danger signals for a small business.

2. Provide participants with a general understanding of the various financial functions that are critical to the survival of a small business.

B. Suggested Teaching Techniques

Present an overview of the main measures that should be monitored by business owners including cash flow, money management and financial ratios. Using the overhead visuals, emphasize the interaction of these various factors in terms of the health and survival of the business.

Participants will be assigned to small groups consisting of 7-10 persons. Each group will be instructed to (1) draw a graphic showing the inter-relationship between cash flow, money management, and financial ratios. This graph can use symbols, pictures and other forms to illustrate the dynamics. (2) develop one example, using a hypothetical business where a decision/action in one component triggers problems in others parts of the business. (3) select one person to be recorder and to present the group's products to the larger group.

Have each group present their respective products. First, the symbolic graph and then the business example. Once all four presentations are concluded, emphasize the following learning points.

1. Small business owners need to view the company as a whole rather than concentrating on a single function.

2. Recognize the long term implications of key decisions in areas such as money management and cash flow.

3. Use financial ratios as measures in monitoring the status of the company.

Materials: Pencils, pads.
Exhibits:
Overhead/ Visuals:
Equipment: Projector and flipchart.

SESSION: FINANCIAL PITFALLS AND DANGER SIGNALS FOR SMALL BUSINESSES

Objectives: To enable participants to recognize conditions and events that may represent serious danger signals for a small business. Furthermore, to provide participants with a general understanding of the various financial functions that are critical to the survival of a small business.

Group B: Entrepreneurs

Activities: Introduction

Small businesses must depend on a carefully managed and balanced process involving the receipt of income and the disbursement of money in such a manner that the enterprise always has an adequate supply of cash and assets to meet its debts and responsibilities. As such the finances of a business represent a delicate balance that depends on a stable inter-relationship between such factors as the flow of cash, financial controls and management, and income/expense ratios.

Accordingly, small business owners must be able to recognize and respond to changes in the financial profile of a company in order to avoid serious financial pitfalls that can severely debilitate a company.

1. Cash Flow

Positive cash flow management can become an important profit center in a business. In practical terms, the cash flow process is a system of transforming assets through a circular process involving: (a) purchasing of goods, (b) manufacturing a product or service, (c) sales, (d) accounts receivable, (e) collections and (f) cash. As such, the process of transforming assets to cash requires a series of critical intermediate stages. Serious delays in any one stage can consequently produce corresponding deviations in the cash flow, i.e., a business runs short of sufficient cash to operate.

Importantly, the system of converting assets to cash is irregular. Profit levels do not equate cash on hand. For example, a company's income statement represents an accrual statement. Sales are recorded as they occur, rather than 30 days or so later when the money is actually collected and received. Thus, in an accrual accounting situation, sales do not always coincide with revenues and expenses.

This basic principle is essential in properly managing the cash flow of a small business. In addition to the accrual accounting system, businesses should have a cash accounting

system that identifies the inflow and timing of cash from different sources.

2. Money Management

The survival and growth of a small business relies on the ability of the entrepreneur to effectively manage the resources and assets of the company. In this regard, money management skills are an important part of the overall picture. There are several critical elements included in the process of money management that are worth emphasizing.

First, the business must have adequate controls on the handling and processing of cash receipts. This includes a system of documentation at the point of sale, all the way to procedures for depositing funds in a bank account. Oftentimes businesses run into serious difficulties due to a lack of adequate procedures and controls on receipts.

Second, business owners need to exercise great care in distinguishing between the assets/cash of the enterprise and personal cash. In certain situations, for example, it is not entirely legal for a business owner to simply "dip" into the cash register to take cash for personal use. This practice may not only violate some laws, but is not good business practice.

Third, a well managed business depends on a sound and accurate accounting system. Besides being a means of documenting the assets and debits of a business, the accounting process provides the business owner with important information about the general financial condition of the company including such indices as sales and receipts, accounts payable, cash flow demands, as well as profits and losses incurred.

3. Financial Ratios

Financial ratios indicate the relationships that exist between various items contained in the balance sheets and income accounts. They are expressed in simple mathematical forms, percentages or other units of comparison.

Different ratios are used to show different types of relationships. Some of the more common ones include net profit on sales, current assets to current liabilities, net fixed assets to tangible worth, sales to inventories and sales to receivables. Likewise, operating profits to interest charges is used as another standard.

In order to be useful, the financial ratios of a company must be compared with an external norm. Each industry has different characteristics, thus the typical ratios in a given type of business tend to be different from others.

There are several sources of standards that provide business owners with a valuable reference point for judging their own financial status/profile. In the U.S., for example, companies such as the Robert Morris Associates and Dun & Bradstreet generate industry-specific ratios. Other companies provide specialized data on industries such as hotels and restaurants as well.

While there is no single cause for business failures, there is general agreement that there is one thing common to all, namely, debts that could not be paid. The mathematical ratios between a businesses' income and expenses is a commonly accepted method of gauging the financial health of an enterprise. As in the instance of cash flow management, there needs to be a proper balance between the input side (income) of the business cycle and the output (expense) generated.

As a general rule, it is recommended that the current liabilities of a business should not exceed 50% to 60% of tangible net worth. Sound companies typically operate at the 40% level. Again, it is important to recognize that these financial ratios vary by industry and by country. Thus, business owners should be familiar with the prevailing ratio standards in their industry and country.

4. Interaction of Factors

Business failures are generally the result of several interacting factors acting in combination with unfavorable circumstances and trends in the market or general economy. Therefore in managing a small business, entrepreneurs need to take into account the business operation as a <u>whole</u> rather than concentrating on any one specific element such as marketing or accounting.

This principle is both practical and essential. In reality, business owners handle a multitude of items on a daily basis that blend management, marketing, and financial decisions. Particularly in smaller operations, the owner/manager must pay attention to the whole enterprise to ensure that each piece of the business is running efficiently, and to watch for "flags" that may signal potential problems.

Decisions in one aspect of the business typically affect other parts of the operation. For example, money management procedures may have a direct effect on the cash flow position of the business, and possibly a long-term effect on some of its critical financial ratios.

<u>Training Exercise</u>

Participants will be assigned to four small groups. Each group will be instructed to:

1. Draw a graphic showing the inter-relationships between cash flow, money management and financial ratios. This graph should rely primarily on the use of symbols.

2. Develop one example using a hypothetical business where a decision/action in one component triggers problems in other parts of the business.

3. Select one person to act as recorder and to present your results to the larger group.

Large Group Summary of Results

Have each group present their two products. First, the symbolic graph and second the business example. Once all four presentations are concluded, use the following learning points to guide the processing and discussion.

1. Small business owners need to view the company as a whole rather than concentrating on single functions.

2. Important to recognize the long-term implications of key decisions in areas such as money management and cash flow.

3. Use financial ratios as a measure to check the general status of the company in relation to established standards, especially with respect to liabilities.

TRAINER'S GUIDE

SESSION:	**CREDIT AND FINANCING**
Module A:	**Loan Policy**
Group A:	**Credit Officers**
Total Time:	**1.5 hours**

A. Teaching Objectives

1. Review the basic purpose of a financial institution; indicate why the loan function and loan policy are important to maintain.

2. Emphasize what the loan policy provides for the bank; expand to a discussion of the objectives of loan policy.

3. Discuss the formulation and implementation of loan policy. Highlight the role of the Board of Directors, the Loan Committee, and the role of the Loan Officer.

4. Emphasize the qualities of a proper loan policy and its place within a bank. Emphasize also the flexibility of a good policy allowing for review and appropriate interest rate structure.

5. Conduct a group discussion related to the participant's own institutions. Conduct an individual and group exercise dealing with improving credit access for small entrepreneurs.

B. Suggested Teaching Techniques

Begin with an introduction of the importance and purpose of a loan policy to an institution.

Go over what the loan policy gives or brings to the bank. Concentrate on outlining the objectives of loan policy. These can be pre-listed on a transparency or on a flipchart for emphasis. Show transparency.

Emphasize how a policy is formulated and implemented. Point out the role of the Board of Directors, the Loan Committee, and the role of the Loan Officer. Show which examples of loans are unacceptable.

Break

Provide an idea of the appropriate qualities and place of a loan policy in the bank. Highlight the other elements of an effective loan policy (periodic review and setting interest rates).

Open up the session to general discussion, and questions and answers. Ellicit reactions, comments, information from the group regarding the loan policy and practices of their institutions toward small business. Watch for individual "policies" that might differ

from institutional policy. Divide the group into smaller units. Have the group's choose a spokesman. Ask each group to determine a loan policy for small business and write down its main characteristics. List the key elements of each group's policy on a flipchart. Look for similarities in the policies presented. Come to a group concensus on the most appropriate loan policy for small business lending.

Materials: Pencils, pads.
Exhibits: The objectives of a bank's loan policy.
Overhead/ Visuals: A transparency listing a good loan policy's objectives.
Equipment: Projector; flipchart and magic markers.

SESSION: CREDIT AND FINANCING

Objectives: To understand the need for a definite loan policy as a basic element to commercial banking

Module A: Loan Policy
Group A: Credit Officers

Activities: Introduction

The basic purpose of any financial institution including commercial banks is to earn a fair return for its shareholders by providing service to the community through the acceptance of deposits and the granting of loans. Thus, a definite loan policy is essential to the protection of the depositers' funds and the production of the shareholders' return.

Loan Function and Bank Income

It should be emphasized that it is the loan function which produces the major portion of a bank's income and therefore it is a major concern and focus of top management.

An established loan policy provides a sound basis and direction for implementing top management's policies, plans and programs. Also, through a sound loan policy, top management can influence profit planning and determine the quality of their institution.

Loans as a Source of New Business

Finally, an established loan policy is also a marketing tool and can be a major source of new deposit business, which in turn become the basis for additional loans, which can attract additional deposits, etc. an imaginative and well planned loan policy toward specific business and industry can attract other similar business firms and industry which share common attributes and problems. This can lead to a bank becoming known in a particular field as a result of sound policy and practices in lending.

1. Objectives of Loan Policy

- Provide Sound Assets and Safeguard Depositor's Funds. The purpose of an established loan policy is to meet the fundamental need for sound assets, protection of depositors' funds and optimizing return to the shareholders. The difficult responsibility of an established loan policy is to balance the conflicting requirements for liquidity and earnings.

- Play a Sound Role in the Economic Development of the Bank's Trade Area. Providing for a sound role in the economic development of its trade area is another reason

for a bank's established loan policy. An established policy insures that loans are made for appropriate purposes in keeping with that objective. It also provides for diversification within the bank's loan portfolio.

- Give Guidance to Loan Officers. In order to achieve a uniform standard for use in discharging their duties, the individual loan officers need an established loan policy. For a uniform program of action for use throughout the entire organization, a much greater requirement in a larger bank or a branch bank. Customers are then assured of receiving equitable treatment in an environment where an established loan policy has been implemented.

- Establish a Standard for Control Purposes. No policy is effective unless there is periodic follow-up to insure that it is being properly implemented. A vital policy is flexible and should function as a guideline rather than an inflexible rule.

  A perpetual loan review program conducted on a systematic basis is the basis for a continuing, accurate, qualitative picture of the loan portfolio, by officers and throughout the bank.

2. Formulating Loan Policy

- Role of the Board of Directors. An established loan policy as merely one facet of the overall policy program for the operation of the bank is established with the approval of the board of directors.

  Among other points, a statement of loan policy generally includes reference to types of loans and the basis upon which they are considered acceptable loan applications. For example, many banks consider loans to be made for speculative purposes to be unacceptable. Unsecured loans to provide the initial capital to be used in the establishment of a new business should not be made when the amount requested would constitute a substantial proportion of the capital. Loans against closely held securities which are not readily marketable are not considered to be appropriate types of loans in numerous policies. One good method of determining types of loans that are not acceptable is to survey the history of chargeoffs.

- Role of Loan Committees. Loan committees play a vital role in any established loan policy implementation. Besides approving or recommending action on designated credits above individual officers' loan authorities, loan committees actually review and interpret loan policy in their decisions in much the same fashion as the board of directors of its designated loan review committee. But more importantly, properly constituted loan committees serve as valuable training grounds for the development and education of the junior lending officers.

- Role of Loan Officer. Finally, it is the individual loan officer who interprets loan policy by the manner in which it is put into practice in his personal dealings with the bank's customers. The finest policy is not worth much if improperly presented to customers through inappropriate practices.

3. Dissemination of Loan Policy

- Loan policy should be disseminated to all appropriate echelons of the bank.

  Loan policy, in order to achieve maximum effectiveness, should be disseminated to all appropriate echelons within the bank and should be made available in written form.

- Loan policy should be stimulative. Written loan policy should give guidance without creating too much centralization of authority. These guidelines should be stimulative rather than restrictive and should provide a facility for the feedback so that appropriate changes can be made in established policy in order to keep it realistic and stimulative, rather than academic and restrictive.

4. Other Elements of Loan Policy

- Periodic Review. For adjusting to changes in loan mix, market, economic climate.

- Setting Interest Rate Structure. Should reflect conditions of credit market, and reflect different terms of loan (i.e., 90 day loan versus 36 month loan, degree of risk, maturity).

5. Loan Policy for Small Business

There should be a willingness to entertain credit applications emanating from entrepreneurs (nascent or established) when they fulfill the basic requirements of the bank's loan policy.

TEACHING AIDS

SESSION: CREDIT AND FINANCING
(MODULE A LOAN POLICY)

THE OBJECTIVES OF A BANK'S LOAN POLICY

1. PROVIDE SOUND ASSETS; SAFEGUARD DEPOSITOR'S FUNDS; MAXIMIZE RETURN TO SHAREHOLDERS: BALANCE REQUIREMENTS FOR LIQUIDITY AND EARNINGS.

2. PLAY A SOUND ROLE IN ECONOMIC DEVELOPMENT OF THE BANK'S TRADE AREA: PROVIDE FOR DIVERSIFICATION WITHIN THE BANK'S LOAN PORTFOLIO.

3. PROVIDES A UNIFORM STANDARD FOR A BANK'S LOAN PROGRAM AND A MEANS OF GUIDANCE TO INDIVIDUAL LOAN OFFICERS.

4. ESTABLISHES A STANDARD FOR THE PURPOSE OF CONTROL; ALLOWS FOR A PERPETUAL LOAN REVIEW PROGRAM WHICH INSURES FLEXIBILITY.

TRAINER'S GUIDE

SESSION:	CREDIT AND FINANCING
Module B:	Credit Administration (Module A: Loan Policy)
Group A:	Credit Officers
Total Time:	1.5 hours

A. Teaching Objectives

1. Indicate that this session outlines the information systems and procedures for loan reporting which give management the tools to achieve maximum income with minimal business loan loss. Consumer (installment) loans and real estate loans (mortgage) are not included here.

2. Point-out and discuss the essential elements of a proper record-keeping system. These include: the collateral record system; the loan classification system; and the loan application for credit.

3. Provide a good introduction to the loan review system.

4. Discuss the loan collection system and the routine procedures associated with it.

5. Summarize the discussion and include the participants' viewpoints/ experience.

Suggested Teaching Techniques

- Begin with an introduction of how proper information systems and procedures help management keep on top of the liquidity problem.

- Go through the essential points of record-keeping which are: the collateral record system, the loan classification system, the application for credit (which is the basis for the loan classification system and the loan review system). A supplementary record which gives the total of all dollar amounts in each classification and the ledger card can also be introduced. List the main points of each system on a flipchart.

- Emphasize the four major purposes of establishing a loan review system. Explain the proper timing for the system and its link to the loan classification system and the application for credit. Indicate the responsibilities of the discount or notes department, the loan review officer, and the individual loan officer in making the system work.

Break

- Briefly discuss loan collection. Show the connection to the loan review system. Indicate the importance of this process to the bank's liquidity.

  Elicit the participants' inputs as to the nature (ask for their examples) of the use of these systems in their institutions.

- Sum-up the teaching units and note the needs for a bookkeeping system, a loan review system, and a loan collection system.

Materials: Pencils, Pads
Exhibits:
Overhead/ Visuals:
Equipment: Flipchart and magic markers.

SESSION: CREDIT AND FINANCING

Objectives: To understand the systems and procedures necessary for sound credit administration relating to business loans.

Module B: Credit Administration (Module A: Loan Policy)
Group A: Credit Officers

Note: This module ties in with material on credit policy (Module A) and credit analysis

Activities: Introduction

This session deals with systems and procedures which relate only to business loans. The purpose of such systems and procedures is to bring together the work dealing with credit files and analysis with the work on credit policy and organization, thus providing management with information systems designed to achieve maximum income with minimal business loan losses.

The systems discussed in this session concern adequate record-keeping in connection with loans, information on the overall condition of the loans and any actions deviating from accepted loan policy.

Normally, loans are classified for accounting purposes into (1) consumer (installment) loans (2) real estate loans (mortgage) and (3) business or other loans.

One of the major problems in banking is liquidity, which is the ability to adjust to changes in deposit levels or changes in the level of loans. For this reason adequate information systems and procedures are essential.

1. Three Basic Systems and Procedures

The systems and procedures relating to business loans can be categorized into three areas: (1) record keeping (2) loan review and (3) loan collection. However, record keeping is the foundation on which other systems and procedures depend for necessary information.

- Record Keeping. The bookkeeping used for handling loans may be simple or complex, depending on the size of the bank, information needs and nature of the business loan portfolio. The system can be operated manually, or by machine. Usually the recordkeeping provides for a ledger card for each borrower which shows:

1) Total amount obligated

2) Composition of amount by specific notes with dates and maturities (final liquidation of loan).

The system and machines used are set up to provide in one operation for posting to the ledger, for the preparing of a notice to the customer at maturity, for the preparation of a file copy to be filed in alphabetical order, and for the preparation of an accrual record.

Whatever system is established can be set up by the bank to meet the overall requirements of the bank and tie it into the general accounting records.

- Collateral Record System. Another system which is supplemented in character to basic bookkeeping records and tied into it is a collateral record. This helps to supervise the maintenance of the proper margin on collateral having a variable value such as stock exchange security and also can be indicative of concentrations in the hands of the bank of large amounts of a particular commodity or security as collateral for loans. There can also be records to show the liability of a direct borrower on endorsed paper, and so forth. In addition, there must also be a complete and comprehensive system of accountability for collateral taken in from customers. This involves the issuance of a receipt to the customer for collateral delivered by him, and a signed receipt from the customer for collateral delivered to him.

  Each of these systems can be constructed to meet the needs of the individual bank and it cannot be said that any one system is superior to all others for all purposes. For this reason, no attempt is made here to reproduce the forms which might be used for these various systems. Rather, attention is called to their variety with the thought that the reader who does not know of a particular system can inquire from those who do and select that one which best fits his own needs.

- Loan Classification System. One system which is deserving of some discussions is the loan classification system. Large banks generally have this in one form or another but there is no standardized method which can be recommended for every bank. Such a system must be constructed to meet the requirements and needs of the specific bank, and it may be simple or complex. What is needed is a means of classifying each loan in a manner that will give needed information to management to aid in the administration of the loan account. Individual notes or customer liability records can be marked by alphabetical or numerical symbols to indicate the nature of a particular loan. For example, management might

want to know what part of its portfolio is business loans and what part is nonbusiness loans. There needs to be a distinction, then, between what constitutes a business loan and what constitutes a nonbusiness loan. Once this distinction is made, each type of loan can be keyed with a symbol indicating its nature. For example, the letter "X" or the number "1" might stand for business loans, while the letter "Y" or the number "99" might stand for non-business loans.

On the other hand, management might want to know more about its loans than indicated by such a simple division. For example, it might be desirable to know how many of the business loans are secured and how many are unsecured. It might also be important to know what the nature of the security is on secured loans or what the general character of the loan is, if it is unsecured. This can be done without much difficulty by merely extending the use of the symbols. For example, the symbol "AX" might mean a loan to a finance company on a note secured by a pledge of installment paper. "AU" might mean a business loan secured by U.S. government securities. "BX" might mean an unsecured loan to a finance company. It can be seen that this type of symbol or the use of numbers in lieu thereof can be extended indefinitely to indicate as many classifications as are deemed desirable.

To provide significant data, it is necessary to have a total of all of the dollar amounts of the loans in each classification. This becomes, then, a supplementary record which can be tied into the total loans. When the total is broken down by classifications at the end of each month, (or classified on the basis of a daily running total) it is possible for management not only to know what the loans are but what changes have occurred since the previous month, the last year-end, or the same month of the previous year. By the use of a system of this type, concentrations can be readily seen and whatever action would appear proper, if any, can be taken as changes occur.

Application for Credit. A basic part of good record keeping for business loans is the application for credit. In a comprehensive system of record keeping this will be fundamental. For each loan made it will show the name and address of the borrower, the amount of the loan, its purpose, the collateral, if any, the rate, endorsements, guarantees, and subordinations, the officer handling, the date approved, and, most importantly, the program of repayment agreed to at the outset.

This form serves as a basis for the loan classification system and for the loan review system which will be

described later. Normally, practically all of the information appears on the facing side. It is not intended ordinarily, that this should be a complex record, bur rather one which is quite simple and which will be filled out by a loan officer, branch manager, or a clerk when the loan is made. The reverse side can be used for more extended comments if believed desirable.

The simplicity of this form should not belie its usefulness or value.

Loan Review. The second major aspect of systems and procedures for business loans is loan review. Long experience has indicated that loan losses tend to be related to lack of attention as much as to inadequate credit standards or inadequate analysis at the outset. Loans which were of good quality when made sometimes drag on and degenerate in quality because of changing circumstances without the banker being aware of it. It is particularly true in larger banks that management can easily be left in the dark regarding the overall quality of the loan account if there is no system of review to bring out the troublesome situations that exist. Therefore, a system is needed from the standpoint of control to provide management with the basic information which shows what is going on in the business loans.

A loan review system serves four major purposes. First, it permits management to detect compliance with loan policy. Second, it assists in detecting any deterioration in the quality of loans. Third, it indicates when collection activity should be actuated. Fourth, it helps to prevent, or at least reduce, losses.

A loan review system can be made to function on the basis of reviewing loans before they are made by working with loan officers or in a committee; it can be made to function as a post review after loans are made; it can be set up to examine maturing loans; or it can be on a periodic basis when the whole account is examined.

Different-sized banks will have varying requirements in this respect and should select a system which best meets their own needs. In order for such a system to work properly the right individual or individuals must be made responsible and must have access, as well as accountability, to top management. In general, in a bank of any size it is probably preferable to have the loan review take place as loans are being approved in a committee; or to have them reviewed immediately after they are made, if there is not committee; or, if there are many smaller loans, approved by individual officers with only the larger ones approved in the committee.

The basis of a good loan review system is the loan classification system and the application for credit which were described before. The loan review system may require an additional supplemental record, depending on how it is set up. If loan review is based solely on reviewing each loan at maturity, all that is needed is a periodic list of loans which are going to mature within the following week or two. If the system is to be more elaborate, it will have its own record which will be a compendium of information about the loan. This record can be in the form shown in Exhibit 1.

EXHIBIT 1
SAMPLE FORM FOR INDIVIDUAL LOANS RECORD

Date_____

Due Date	Customer	Endorser	Class	Rate	Amount	Total	Debit	Ok'D by

It will be noted that this indicates the date of the loan, the borrower, the classification of the loan, the maturity, the officer handling, the program of payment, and the payments actually made. The information for this is obtained largely from the application for credit. The record is maintained by the discount or note departments. These sheets or tickets can be delivered to the loan review officer once each week or two weeks for all notes maturing in some succeeding period. This gives the loan review officer an opportunity to determine which loans are badly off schedule as far as repayment is concerned; to review the credit files if needed; and to discuss the matter with the individual loan officer. This, then, can be recorded in comments on the sheet which is delivered to

the loan officer at the beginning of the week in which the note matures. By this method the loan officer is apprized of all his loans which are maturing, their condition, and whether they are in accordance with the original understanding.

Besides this, he learns of any criticism of the loan by the loan review officer and knows that it is a matter of record. This enables him to act accordingly and to exert whatever efforts he deems advisable to correct a criticized loan situation.

In this kind of system, the loan review officer may reclassify loans which, in his judgment become slow or unsatisfactory. Inasmuch as the total of such loans is brought to the attention of management periodically, any strong movement into the unsatisfactory categories is promptly detected so that proper action can be taken.

Whatever the circumstances may be in the individual bank, a good loan review system can be helpful. Recognizing that it is the people who make the system work, the simpler and more informative the system the greater the ease with which the loan review function can be carried out.

In addition to any more or less elaborate loan review system which might be established along the foregoing lines, there is one other simple but effective record which should be prepared by the discount or note department. This is a listing of all notes which are past due. This can be done as frequently as seems desirable although once weekly should usually be satisfactory. Such a listing is likely to be most helpful if past-due notes are grouped by loan officer, loan group, and in order of maturity. If the loan classification symbol can be shown as well as the loan's collection status, more use can be gotten from the report.

Such a listing should go to all loan officers and to senior management. Follow-up in detail should be the duty of the loan review officer but circulation of such a list can be a vital factor in getting attention and action from those responsible for the handling of these loans which are listed.

Loan Collection. The third aspect of the systems and procedures for business loans relates to collections. This is concerned with the routine procedures necessary to effect an orderly collection and turnover of the loan account.

Collection activity is going to be based on the loan review system. This needs to be coupled, as indicated above, with some periodic statement of the loans which are past due and which need attention. It is from this source that potential difficulties may first be discovered. The loan review system indicates to individual loan officers which borrowers are repaying in accordance with the agreement and which are not. They can then take whatever steps are appropriate to effect collection of the amounts that are supposed to be paid or of modifying the program of payment to fit changed circumstances on the part of the borrower. This activity keeps the loan account turning over and prevents individual loans from becoming frozen. This very process provides for the liquidity of the bank, and in periods of tight money makes funds available for relending to those in need.

Summary/Discussion. Systems and Procedures for Credit Administration in connection with business loans are for the purpose of providing adequate record keeping, management information, adherence to policies, and minimum losses. Such systems and procedures normally function through the discount or note departments. From the standpoint of internal control and audit, there needs to be a bookkeeping system, which may be manual, or machine operated by any of a number of satisfactory types of machines.

Systems supplemental to the record keeping system are required to provide management information. Primarily these are an application for credit form and a loan classification system which supply management with that data needed to properly perform its own function.

There also needs to be a system of loan review to make sure that policy is being followed, to detect deterioration in quality of loans, and to provide for actuating collection activity. This review function performs best when accompanied by a periodic examination of all loans.

Finally, there should be a system for handling of collections on loans which become past due or where the programs of repayment are not being fully met.

Without these systems bank management is likely to have real difficulty in knowing whether its desires are being fulfilled and whether unwise loans are being avoided.

TRAINER'S GUIDE

SESSION:	TOOLS AND TECHNIQUES USED BY BANKERS IN ANALYZING LOAN REQUESTS
Group A:	Credit Officers
Total Time:	3 hours

A. Teaching Objectives

1. Review/discuss the tools and techniques used by bankers.
2. Provide definitions of key financial statements along with demonstrations.
3. Conduct exercises in balance sheet, profit and loss statements.
4. Emphasize the importance of those tools and techniques to bankers and to business owners.
5. Provide examples of ratio analysis and their importance in analyzing loan requests.

B. Suggested Teaching Techniques

Begin with open discussion of the key financial statements used by lenders for financial analysis. Refer participants to exhibits of (1) profit and loss statement; (2) balance sheet. Explain difference and importance of each.

Go through the components on a flipchart of each of the financial statements and comment on each item.

Using the forms provided to participants, review the basic definitions of different types of ratio analysis. (Show transparencies of ratios.) Then go through exercise of (1) liquidity analysis; (2) profitability analysis; (3) leverage and debt service (capital ratio analysis). Obtain class opinion on leverage management. Use Case Study #1.

Break

Discuss the technique of forecasting future operations and its importance to making a credit decision. Refer to transparency for financial projections. Ask participants what forecasting techniques they use and what data are available for making forecasts.

Review the session's content and activity and open up to questions and answers. Relate the mechanical tools and techniques to the judgmental factor of character, experience and applicant and how this relates to loan decisions in spite of or along with financial statements.

Materials:	Pencils, pads, Case Study, pie charts, definitions.
Exhibits:	Profit and loss statement and balance sheet.
Overhead/ Visuals:	Graphic circle of financial tools; chart of the inter-relationship of financial projections, financial statement.
Equipment:	Projector.

SESSION: TOOLS AND TECHNIQUES USED BY BANKERS IN ANALYZING LOAN REQUESTS

Objectives:

1. To review and understand the specific tools and techniques for making loan decisions
2. To emphasize need to identify small enterprise cash needs.

Group A: Credit Officers

Activities: Introduction

Loan decisions are based on the evaluation of financial, management and economic factors; however, the most demanding task in making a loan decision is financial analysis. Following is a discussion of the range of financial data and array of tools for analysis.

1. Financial Statements

- Basic Elements. Financial statements of the individual firm are the most important source of financial data. Varying numbers of statements, schedules, and exhibits are presented, but three are fundamental. They are: (1) the balance sheet depicts the financial condition of the business at the end of a specified day; (2) the profit and loss statement summarizes the financial operations over a period of time; and (3) the reconciliation of the capital accounts summarizes changes in them from one balance sheet date to another. In addition to showing the amounts paid out in dividends, it is most important in pointing out changes resulting from revaluation of assets or investment of additional funds.

  A number of other schedules, exhibits, footnotes, and textual material may be included in the more comprehensive financial statements. Among those found with some degree of frequency are ones giving more details on:

  1. The auditor's opinion or statement of the scope of the audit.
  2. Individual items of assets (such as cash and investments) and liabilities (such as notes or bonds payable) given as a single total in the balance sheet.
  3. Insurance coverage.
  4. Sources and application of funds. This is one of the most useful of all tools available to the credit analyst. In it are summarized all the activities of the firm which increased or decreased its cash position. Sources of funds include net profits after payment of

income taxes, non-cash-consuming expenses such as depreciation and depletion, a decrease in working capital indicating a greater increase (or smaller decrease) in current liabilities than in current assets, an increase in long-term debt, gains on the disposition of assets, and sale of additional capital stock. Uses of funds include payment of dividends, an increase in working capital, reduction of long-term debt, losses on the disposition of assets, and acquisition of treasury stock. This statement, then, is a very important summary of past operations and a source of leads for further investigation by the credit analyst.

5. Cost of goods manufactured, selling expenses, administrative expenses, or other income and expense data summarized in the profit and loss statement.

6. Explanatory text or footnotes by the auditor explaining any of the figures in the financial statement.

All of these schedules and exhibits contain information that may be particularly useful to the loan officer in analyzing specific loan requests.

- <u>Reliability</u>

  - The value of these statements to the loan officer varies directly with the degree of confidence he can place in their accuracy. Statements prepared by outside accountants generally are given more credence than those prepared internally by members of the borrower's own staff. Next, the loan officer may take into account his or his associates' estimate of the caliber of work performed by the outside firm. In the absence of sufficient experience with the individual firm he may consider statements prepared by CPA firms to be more reliable than those prepared by other accountants. The opinion of the accountant is a most important part of the presentation, for it expresses his opinion on the reliability of the statements presented. He may express an unqualified opinion that the statements present fairly the financial position and results of operations in conformity with generally accepted accounting principles consistently applied with those of preceding periods. A qualified opinion is used when the accountant was not able to make a sufficiently detailed examination or where departures from generally accepted accounting principles are found, but where he believes the statements are a generally fair presentation. Finally, he may disclaim an opinion because of limitations in the scope of the audit or departures from generally accepted accounting principles. If the books have not been audited, the accountant may merely note on

the statements "Prepared from the books without audit." The loan officer should consider the nature of the opinion, or the absence of it, in determining the reliability of the statement as a basis for extending credit.

- Financial statements based on complete audits and bearing unqualified CPA opinions frequently are a prerequisite for granting loans, for they are the major safeguard of accuracy available to a loan officer. Even so, other investigations or considerations may be in order. Explanatory notes accompanying the statements offer a good starting place. For example, investments in subsidiaries may be valued at cost. This will understate or overstate the value of the investment (and net worth) depending upon the profitability of the subsidiary's operations. Methods of valuing inventories and fixed assets similarly may be clarified in the explanatory notes. In a period of rising costs, for example, valuation of inventories on a FIFO (first in first out) basis would result in a higher net profit (and net worth) than would a LIFO (last in first out) basis. Net worth also would be larger in such period of rising costs, where fixed assets are revalued upward periodically, than it would be if they are reported on the basis of cost less depreciation. And, in this latter case, the methods of calculating depreciation in turn will result in different net worth figures but still permit the CPA to express an unqualified opinion. Numerous other types of explanations may give the loan officer valuable leads.

Explain this by example

- A detailed reading of the statements line by line provides further insight into the financial condition of the prospective borrower. Some unusual accounting treatments may be seen, especially in the case of internally prepared statements. One of the more frequent is deduction of an overdraft in the bank account from current assets rather than adding it in as a current liability. This distorts in favor of the prospective borrower any ratios using either current assets or current liabilities. (These ratios will be discussed later in this chapter.) Similarly, equities in real estate or equipment sometimes are listed as assets (net after deducting sums owed on them) rather than listing the net depreciated value as an asset and the amount of the real estate or chattel mortgage as a liability. This practice does not affect net worth, but it does change any ratios based on fixed or total assets or liabilities. Discovery of these or similar unusual treatments of accounts should put the loan officer on guard. They should not be found in externally prepared statements having an unqualified opinion.

- Technical correctness of presentation and consistency with prior statements is not sufficient for the loan officer, however. He needs to satisfy himself that the asset values are reasonable, that currentS assets normally could be liquidated in a reasonable time, that all liabilities of which he has knowledge are shown, and that contingent liabilities which may become full liabilities of the borrower are shown. Some leads on these matters are included in notes accompanying the statements. For example, differences between the value of stock in a subsidiary on the books of the parent corporation,the pro rata value of that stock according to the capital accounts of the subsidiary, and market value of that investment where a quoted market exists may be pointed out in a note. Contingent liabilities under lawsuits or guarantees of debts of subsidiaries should be noted also. Any changes in value (revaluation) of assets should be shown in the statement reconciling changes in the capital account from the preceding balance sheet date to the current one.

- The loan officer is not restricted to material in the statements. Bank records relating to notes payable to the bank, and balances in demand or time accounts with the bank, frequently can be cross-checked with balances shown in the statement of condition. Furthermore, a loan officer should have some opinion of the value of many of the principal fixed assets, based on observations made during officer calls on the borrower at his place of business. These considerations are especially important where internally prepared statements are the only ones available. CPA audit statements frequently are not available in smaller towns or for smaller accounts in larger cities. In such cases the loan officer needs to make as many independent tests as possible and to use any available supplemental sources of information such as income tax returns.

NOTE: This may be particularly applicable to workshop participants

- Group Review/Exercises

2. Ratios and Other Financial Relationships

Many ratios and other financial data are available to assist the loan officer study the financial condition of a firm. All of them would not be used for each loan application, but each has some significance of its own and can help in analyzing some special aspect of the financial condition. The loan officer, then, should know their significance, limitations, and interrelationships in order to use them effectively.

Working capital is a financial concept which is universally recognized and used as much as any other. It is the difference between current assets and current liabilities. Its accuracy and value depend upon the exactness with which assets and liabilities classified in the current categories

are valued. It is especially useful in determining whether a firm may have sufficient assets convertible into cash in a relatively short period of time (a year) to pay the liabilities maturing in that same period, with some margin of safety being left to take care of the unforeseen emergency.

Other financial data set forth in absolute, dollar terms relate to profits. Included are net operating profits, net profits after taxes, and net profits retained in the business. They are major measures of a successful operation, and hence important in any credit analysis.

Most comparisons of data in financial statements are made in terms of ratios (or relative amounts) rather than absolute or dollar amounts. They are computed by dividing one total by another, the answer being expressed as a decimal number or a percentage. Ratio analyses are facilitated if the numerator and denominator are arranged so that the ratios increase in size as the financial strength of the firm improves, that is, a ratio of 2.4 to 1 indicates a better condition than 1.8 to 1.

Ratios may be grouped into three general classes according to the relationships they show or purposes they serve: (1) liquidity, (2) profitability, and (3) capital. These categories may not be watertight, but they are useful tools of analysis. All three enter into almost every credit decision, but the relative importance of each varies with the nature of the credit. Seasonal loans are paid out of the relatively quick conversion of assets into cash. Thus, a loan officer evaluating a seasonal loan application probably would consider the liquidity ratios more completely than the profitability ones, but he would not disregard the latter. And, when evaluating a term loan to be paid out of profits of successive periods, he would reverse the weights. In both cases he would keep capital ratios in mind because of the safety factor they provide for unexpected emergencies.

The nature of, and method of calculating, the various ratios may be illustrated by the following simplified balance sheet and profit and loss statement of the XYZ Department Store, Inc. (Exhibit 1). The lines have been numbered for ease of reference.

- Refer to examples and go through each statement example

- Review material/presentation with open question/answer period

  - Liquidity Ratios

    The current ratio (A7 - L6 = 2.29) expresses the relative size of current assets as compared to current liabilities. These are the same data used in calculating working capital, but two firms with the same

EXHIBIT 1
XYZ DEPARTMENT STORE, INC.
Profit and Loss Statement
Year Ending December 31, 1965

P 1	Net sales		$1,015,347
2	Less: Cost of goods sold		637,942
3	Gross profit on sales		$ 377,405
4	Expenses:		
5	Selling	$156,948	
6	General	170,898	
7	Other	20,926	
8	Total Expenses		348,772
9	Net profit before income taxes		$ 28,633
10	Less: Income taxes		10,762
11	Net Profit after Income Tax		$ 17,871

EXHIBIT 2
XYZ DEPARTMENT STORE, INC.
Balance Sheet
December 31, 1965

Assets

Reference No.			
A 1	Current Assets:		
2	Cash	$ 34,924	
3	Accounts receivable	151,200	
4	Merchandise inventory	205,383	
5	Marketable securities	4,057	
6	Other	7,858	
7	Total Current Assets		$ 403,422
8	Fixed Assets:		
9	Furniture, fixtures, equipment-net	$ 64,404	
10	Real estate	45,761	
11	Total Fixed Assets		110,165
12	Total Assets		$ 513,587

Liabilities

L 1	Current Liabilities:		
2	Accounts payable	$ 58,549	
3	Notes payable-bank	55,776	
4	Income taxes payable	12,686	
5	Other	49,150	
6	Total Current Liabilities		$ 176,161
7	Long-Term Liabilities:		
8	Notes payable-bank	$ 33,845	
9	Notes payble-other	13,096	
10	Total Long-Term Liabilities		46,941
11	Total Liabilities		$ 223,102

Capital

C 1	Capital Stock	$100,000	
2	Surplus	190,485	
3	Total Capital		$ 290,485
4	Total Liabilities and Capital		$ 513,587

amount of working capital could have very different current ratios. For example, a firm with $803,422 in current assets and $576,161 in current liabilities would have the same working capital as the XYZ Department Store, Inc., with $403,422 in current assets and $176, 161 in current liabilities. The current ratio of the former would be 1.39 to 1, though, whereas the latter is 2.29 to 1. It gives the creditor a clearer picture of the relative margin of protection he has in current assets for collection of the amount owed to him.

The quick or acid test ratio is more severe in nature and less frequently used than the current one. It is computed by dividing cash plus current receivables by current liabilities ([(A2 + A3) - L6 - 1.06]. Most firms are not as fortunate as the XYZ Department Store and must convert inventory into cash through sales to meet current liabilities fully. Another firm with cash and receivables of $200,000 and current liabilities of $300,000 would have to realize a net of at least $100,000 from sale of goods in order to pay current liabilities in full. Without these sales, at least one third of the current liabilities could not be paid through normal business activities.

The net sales to receivables relationship (or turnover of receivables) is expressed either as a ratio or in number of days sales (P1 - A3 = 6.72). In businesses with marked seasonal differences in sales, an average of the amounts outstanding at the end month or each quarter may be more representative than the end-of-the-period figures. This ratio shows the number of times a year that the receivables turn over. It can be converted into days sales by dividing either 360 or 365 days by the ration (360 - 6.72 = 54 days) on the assumption that all sales are on accounts receivable. Where appreciable amounts of sales are for cash, a further refinement of using net sales on account instead of (total) net sales would give a more accurate turnover figure. Receivables turnover, either as a ratio or in terms of days sales, is especially useful in two areas. First, it shows the approximate length of time before the current trade receivables probably will be collected and turned into cash. Then, when compared with the terms of credit sales, it gives an estimate of the quality of the receivables. The best estimate of the latter, of course, is a comparison of charge-offs for bad debts with receivables or credit sales, or an actual listing of the receivables by maturity dates.

Cost of goods sold to inventory (inventory turnover) is another index of liquidity. It too may be expressed as a ratio or in number of days sales (P2 - A4 = 3.11) or (360 - 3.11 = 116 days). Using the end-of-the-period inventory probably would overstate the turnover because

fiscal years are selected to end at a time when inventories are low. This cold be corrected by using an average of the inventories at the end of each month or of each quarter. A ration based on cost of goods sold (P2) is more accurate as a measure of turnover than is one based on net sales (P1) because inventory figures are maintained on a cost basis. Net sales exceed the cost of goods sold by the amount of the markup. Hence, ratios based on net sales would show a larger turnover than would those based on cost of goods sold for the same period. These ratios give an insight into the liquidity of the inventory by showing how many times it turns over in a year, or how many days it takes on the average to sell it. Most merchants believe that increased turnover is desirable to increase profits, but too much reliance must not be placed on the inventory turnover ratio to indicate profitability (even though profitable firms usually have a high turnover). The faster turnover may be the result of price reductions which cut the gross profit margin, or the higher sales may be the result of increased advertising or other selling expenses. It also might be the result of an understocked condition - a danger signal.

Two similar ratios relate cost of goods sold or net sales to fixed assets or to total assets of the firm. These are not liquidity measures in a strict sense, but they do indicate the efficiency of the firm in using fixed or all assets in generating sales. This can be helpful in comparing performances of firms in the same industry. As in the case of inventory turnover measures, however, increases in these ratios do not necessarily indicate increased profits. Since neither fixed nor total assets fluctuate as widely as inventories or receivables, a monthly or quarterly average of them might not be needed.

Profitability Ratios

While turnover ratios affect profitability, ratios based on profits themselves are more reliable indicators. Various profit figures appear in the operating statement, but net profits after income taxes are the most significant; these are the funds available to management to pay debts, to expand the business, and to reward the owners. The most useful profitability ratios relate net profit after taxes to net sales (P11 - P1 = 1.76%), to fixed assets (P11 - A11 = 16.22%), to total assets (P11 - A12 = 3.48%), or to tangible net worth (P11 - C3 = 6.15%). These relationships usually are expressed as percentages rather than decimal numbers since the net profits after taxes almost always are smaller than the other figures. The ratios of net profit after taxes to net sales and to tangible net worth are more useful for intercompany comparisons than

are those to fixed assets and to total assets. One firm might lease much equipment and real estate, while another might own them. Leasing would affect the totals of fixed or total assets, and hence the ratios of profits to these amounts. The latter ratios, then, would be significant for year to year comparisons only within the same firm, and then again only when leasing practices of the firm had not changed.

The main objective of a businessman is to maximize net profits after taxes as a percentage of tangible net worth, that is, to maximize the return on the investment. Hence, this is one of the most significant ratios for the loan officer. It illustrates very clearly, though, the point that various ratios should be used in concert, rather than alone, in analyzing a credit application. An extremely high ratio of profits to tangible net worth, for example, might be the result of a very small capital investment and an extreme reliance on credit for funds to operate the business, a point of weakness rather than of strength. The loan officer then would look at the capital ratios to check this point.

Capital Ratios

Tangible net worth is the common factor in capital ratios. It does not include the value of intangibles such as goodwill even when purchased, patents which have been obtained only after large expenditures on research and development, and trademarks which have a following built up through large expenditures on advertising. If this is an overly conservative step in some cases, the loan officer may note it in making his analysis.

The financial data most frequently compared to tangible net worth in various capital ratios are total debt (C3 - L11 = 1.30), fixed assets (C3 - A11 = 2.64), and net sales (P1 - C3 = 3.50). Practice may vary as to which of these factors are used as numerators and which are denominators, but it seems helpful to divide tangible net worth by total debt and by fixed assets. In most, but not all, industries tangible net worth is the largest of two of the three figures. Thus, making it the numerator in the fraction usually gives a ratio greater than 1 to 1. And the larger the ratio, the more favorable is the condition of the business for extension of loans to it. For the same reasons it is desirable to divide net sales by tangible net worth rather than the opposite. Sales per period usually exceed net worth and the larger the ratio the more favorable the business standing, other things being equal.

Capital ratios should be included in any financial analysis, for they (except sales to worth) indicate the financial ability of a firm to absorb losses and still pay its obligations. The sales to worth ratio, especially on a year to year comparison, shows the effectiveness of management in using the investment to produce sales and — hopefully — profits.

Computation of all the above ratios and other financial data is not necessary for each credit analysis. Loan officers and credit men develop a rather standard group used in most analyses, and then employ others if this preliminary survey shows areas where more detailed study is desired. Those which are most useful for initial general surveys are working capital and net profits after taxes (either earned or retained in the business) as dollar figures, the current ratio, the receivables turnover and inventory turnover to indicate liquidity, the profits to sales and profits to worth ratios to indicate profitability, and the net worth to debt ratio to indicate the overall capital protection for a creditor. These form an almost irreducible minimum to obtain a general survey. Then, depending upon the purpose and nature of the loan and conditions brought out in the initial survey, other ratios may be computed. The loan officer should be aware of the usual relationships between the various ratios and other financial data, and investigate any unusual ones. For example, if the profit to sales ratios are high, one would expect high inventory turnover ratios. On the other hand, high profit to net worth ratios might indicate an undercapitalized condition and too much reliance on credit.

An unsophisticated, quick, empirical test of the need for detailed analyses is a review of the amounts and promptness of payment of previous loans by the borrower and his record of promptness in meeting trade obligations.

Trends in financial data and ratios are more significant to the loan officer than is the static condition at any one time, or for any single period of time. These generally are brought out in "spread sheets" providing columns for five or more years. The exact number of years considered significant will vary with a number of factors. Generally five years is sufficient, but changes in economic conditions, the executive structure, or product or service, might limit the comparison to a shorter period.

Spread sheets usually contain five sections:

1. Balance sheet data are given in about as much detail as is given in the statement of a moderate-sized firm.

2. Information in the profit and loss statement is summarized.

3. The net profit after taxes figure logically leads into a section beginning with the old net worth, summarizing changes in net worth of the firm for that period, and ending with the new net worth.

4. Then financial figures and pertinent ratios are listed.

5. A final section traces the sources and application of funds. This statement is discussed above in the section on Financial Statements.

Interyear comparisons for the individual firm are made by using a uniform group of accounts for the period and by placing the data for successive years in adjacent columns. Where large changes in total resources, liabilities, or sales have taken place, comparisons may be facilitated by preparing other spread sheets in which the increases or decreases of dollar amounts are given rather than the actual figures in the financial statements. Another basis of comparison is provided by reducing balance sheet data to percentages of total resources and profit and loss data to percentages of net sales. This latter treatment facilitates comparisons with other firms in the same industry as well as interyear comparisons for the same firm.

Industry Comparisons

Comparisons of data for one year or trends for several years with those for other firms in the same industry may be very helpful in locating points of strength or weakness in a difficult loan application. These comparisons can be made directly between financial statements of firms if several of about the same size in the same industry are furnishing statements to the bank. Comparison of data for firms in different industries would be of little value since technical conditions vary widely between industries. For this reason standards for the various liquidity, profitability, and capital ratios were not set forth above. As a matter of fact, they may vary within the same industry between firms of different sizes. Interfirm comparisons are made almost entirely on the basis of ratios and of percentage distributions of balance sheet accounts and profit and loss statement accounts.

An excellent source of comparative data is the bank's credit files of other firms in the same industry. Where a large enough sample can be assembled, these files may prove to be more helpful than the general summaries in

the sources cited above. More details are available, and, since the loan officer is acquainted with the circumstances of the individual firms, they can be interpreted more accurately. Furthermore, salient data of the individual firm are not watered down or obscured.

Other Sources of Financial Data

The loan officer's work would be easier if all credit applications were accompanied by audited statements with supporting schedules, exhibits, and explanations. Less-experienced businessmen and individuals, especially in small businesses and on farms, may not have the records needed for complete, accurate statements. In such cases supplemental sources of information must be developed. Pro-Forma statements which take into account the techniques of financial projection can be useful tools for the financial analyst. "The main techniques of financial projection (forecasting) fall into three categories - operating budgets, financial budgets, and pro forma financial statements. Operating and financial (cash) budgets are projections dealing with key sections and elements of the business operation, while pro forma financial statements represent a forward look for the business as a whole, in the form of the usual balance sheet and income statements. In all three cases we are talking about the arrangement of basic physical and financial data as the starting point for planning activities. These efforts are not only necessary for the short run, but also become a basis for truly strategic long-range thinking.

Note: Obtain participant country sources of data if they are available

Income tax returns are a valuable substitute for, or supplement to, financial statements. They have the advantages of availability, since any business or individual with a net income must file a return, and of being a fairly reliable indicator of profits measured according to relatively fixed standards. Balance sheets are included in returns of many businesses; however, they may not accurately reflect financial condition since asset values may be either understated or overstated.

TEACHING AIDS

EXHIBIT 1

THE STANDARD FINANCIAL RATIO FOR CREDIT ANALYSIS

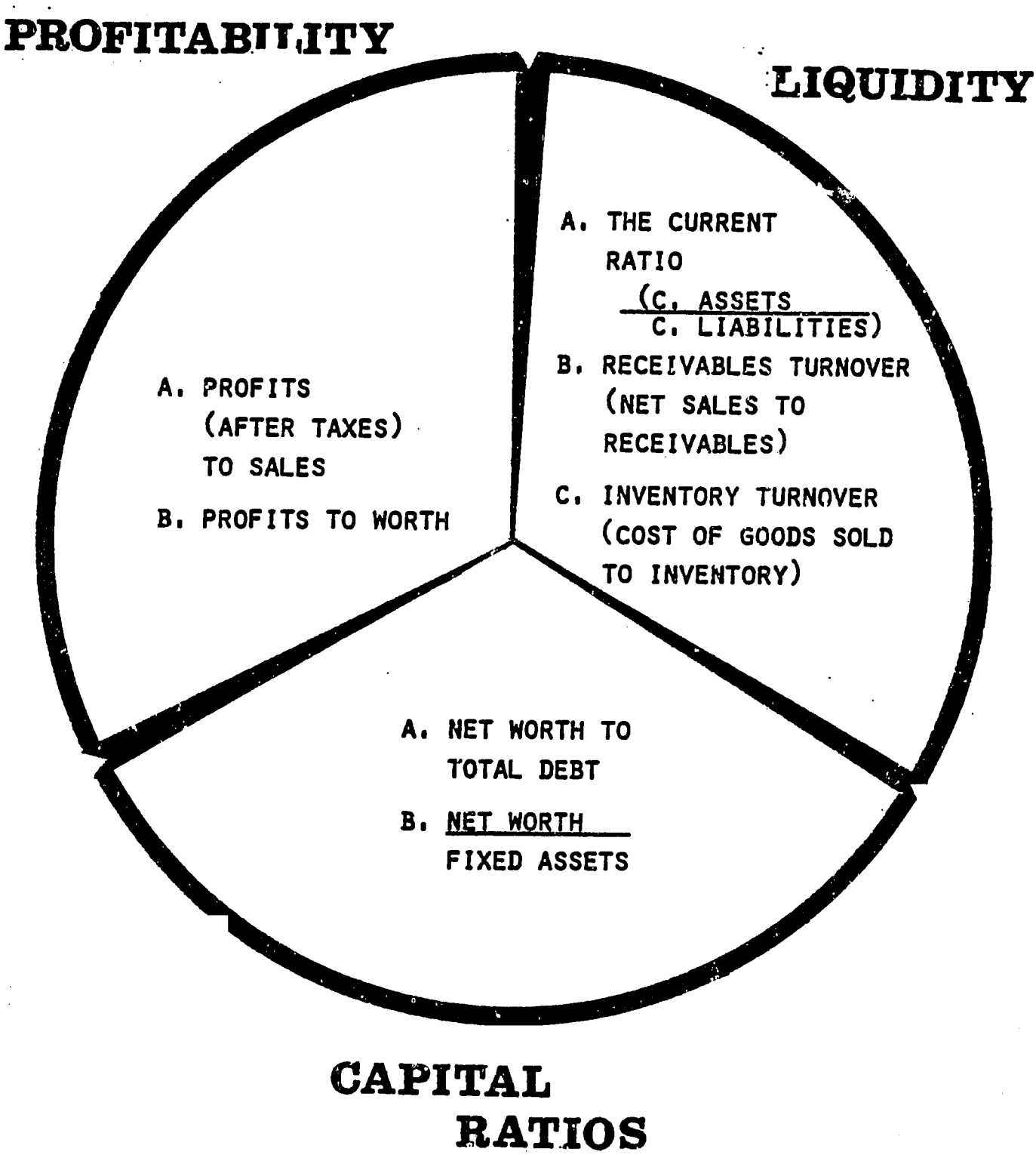


EXHIBIT 2
DEFINITIONS OF BASIC BALANCE SHEET RATIOS USED IN FINANCIAL ANALYSIS

1. Liquidity Ratios

(Used to determine whether a firm has sufficient assets convertible to cash in a short period of time to pay the liabilities maturing in the same period with margin of safety.)

A. The Current Ratios

It expresses the relative size of current assets as compared to current liabilities. It gives the creditor a clearer picture of the relative margin of protection he has in current assets for collection of the amount owed to him.

B. The "Quick" or "Acid-test" Ratio

It is more severe in nature and less frequently used than the current one. It is computed by dividing cash plus current receivables by current liabilities.

C. Net Sales to Receivables (Turnover of Receivables)

It shows the approximate length of time before the current trade receivables probably will be collected and turned into cash. When compared with the terms of credit sales, it gives an estimate of the quality of the receivables.

D. Cost of Goods Sold to Inventory (Inventory Turnover)

These ratios give an insight into the liquidity of the inventory by showing how many times it turns over in a year, or how many days it takes on the average to sell it.

2. Profitability Ratios

Derived from using net profits after income taxes compared to net sales, fixed assets, and to tangible net worth. They show whether there are funds available to management to pay debts, to expand the business, and to reward the owners. Usually expressed as percentages rather than decimal numbers since the net profits after taxes are almost always smaller than the other figures.

3. Leverage and Debt Service or Capital Ratios

These ratios indicate the financial ability of a firm to absorb losses and still pay its obligations. They are usually tangible net worth to total debt and to fixed assets. A net sales to worth ratio shows the effectiveness of management in using the investment(s) it has made to improve/produce sales and hopefully, profits.

EXHIBIT 3

INTERRELATIONSHIP OF FINANCIAL PROJECTIONS

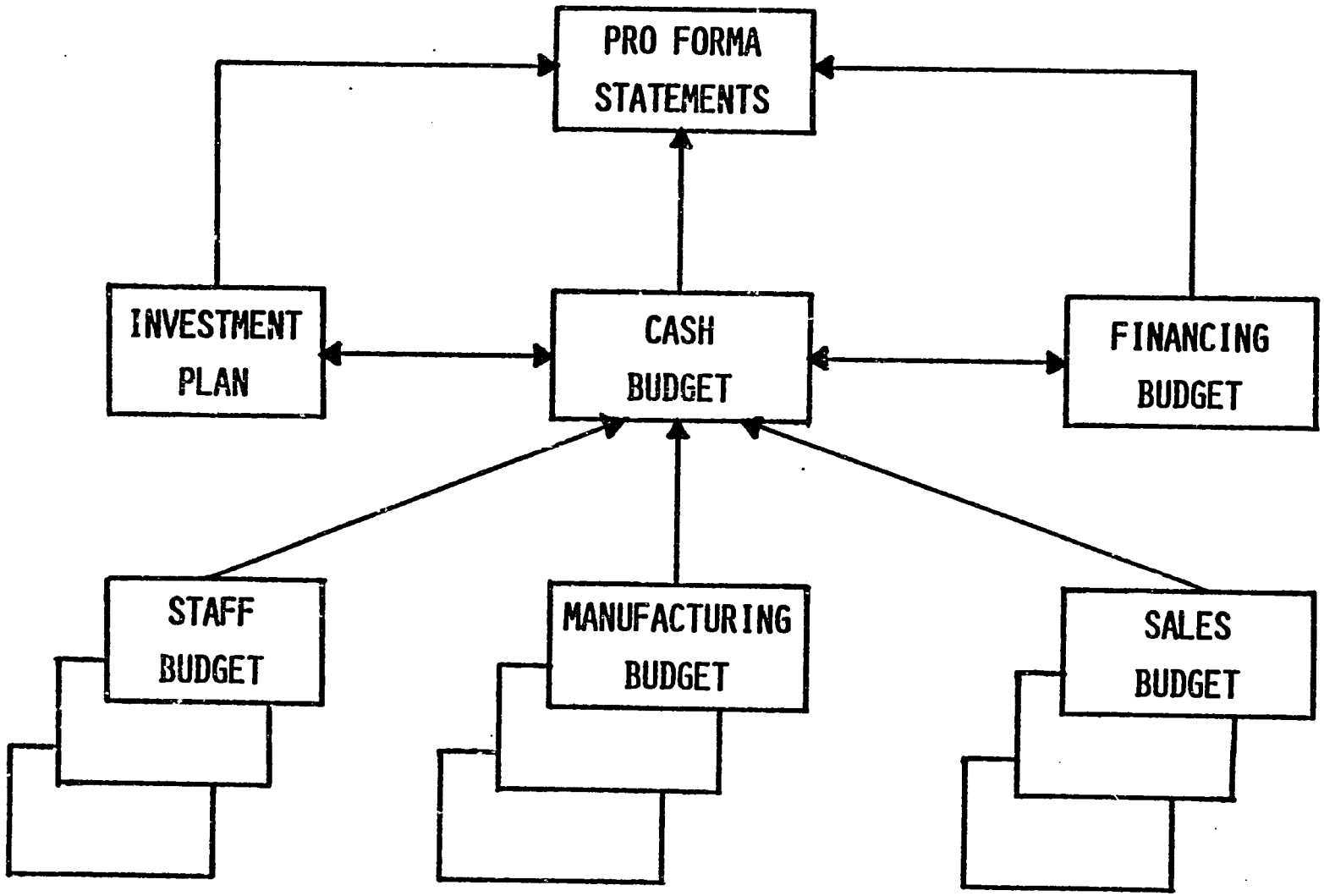


EXHIBIT 4

CASE STUDY #1

Lenders

From the following financial statement of the ABC Company for 1986 and 1987, prepare the ratios and measures discussed from the viewpoint of lenders.

Comment on the changes shown between the two years, and discuss the significance of the results. Indicate which additional kinds of comparison you would like to make for this company, a manufacturer of electronics, and the type of information you would need.

CASE STUDY #2

Ratio Analysis

What is the change in a company's current ratio of 2.2:1 (current assets are $573,100) if the following actions are taken individually? Also, how does each item affect working capital? The company:

1. Pays $67,500 of accounts payable with cash.

2. Collects $33,000 in notes receivable.

AEC COMPANY

Balance Sheets

December 31, 1986 and 1987
($ millions)

Assets

	1986	1987
Current assets:		
Cash	$ 82.7	$110.9
Accounts receivable (net)	92.6	146.2
Inventories	88.8	129.5
Prepaid expenses	2.8	6.2
Advances from government	5.3	2.8
Total current assets	272.2	395.6
Property, plant, and equipment	215.2	283.4
Less: Accumulated depreciation	101.2	119.6
Net property	114.0	163.8
Other assets	3.1	4.2
Total assets	$389.3	$563.6

Liabilities and Net Worth

Current liabilities:		
Accounts payable	$ 43.4	$ 62.9
Accrued income tax	36.7	44.0
Accrued pension and profit sharing	27.1	31.2
Other accruals	21.9	38.4
Current portion of long-term debt	2.1	-
Total current liabilities	131.2	176.5
Debentures (9% due 1989)	-	94.0
Other long-term debt	7.8	4.1
Deferred income tax	5.2	7.6
Common stock ($1 par)	10.1	10.2
Paid-in surplus	25.1	27.2
Earned surplus	209.9	244.0
Total liabilities and net worth	$389.3	$563.6

TRAINER'S GUIDE

SESSION:	REASONS FOR FAILURE OF SMALL BUSINESS
Group B:	Entrepreneurs
Total Time:	3 hours

A. Teaching Objectives

1. Provide participants with an increased understanding of the principal management, economic and financial factors associated with failures among small business enterprises.

2. Enable participants to apply these same principles to the management and operation of their businesses.

B. Suggested Teaching Techniques

Introduce the basic factors that contribute to small business failures.
Review the key factors contained in participant handouts including Management Factors, Financial Factors and Economic Factors.

Conduct training exercise with participants working in small groups on the following tasks:

1. Identify key management, financial and economic factors that contribute to business failures.

2. For each factor develop a set of strategies to increase business success and minimize failures.

3. For each strategy suggest specific management actions and practices that are important in promoting a successful enterprise.

4. Participants will work in small groups on the following tasks:

   - Identify the key management, financial and economic factors that contribute to business failures.

   - For each factor develop a set of strategies to increase business success and minimize failures.

   - For each strategy suggest specific management actions and practices that are important in promoting a successful enterprise.

NOTE TO TRAINER: Form three to four small groups. Provide instructions to group, together with flipchart paper and markers. Each group should assign one individual to serve as a recorder.

5. Large Group Summary of Results

NOTE TO TRAINER: Process the results of each group with an emphasis on the identified survival and growth strategies developed in response to each of the failure factors.

If feasible, the products from each of the small groups should be typed and copied for distribution to all participants.

Process the products of each small group. Focus attention on the identified survival and growth strategies developed in response to each of the failure factors. If feasible, the small group products should be typed, copied and distributed to all participants.

Materials:
Exhibits: Group Process Matrix.
Overhead/ Visuals: Interaction of management, financial and economic factors.
Equipment: Projector, flipchart.

SESSION: REASONS FOR FAILURE OF SMALL BUSINESSES

Objectives: To provide participants with an increased understanding of the principal management, economic and financial factors that are associated with failures among small business enterprises. Furthermore, to enable participants to apply these sample principles to the management and operation of their businesses.

Group B: Entrepreneurs

Activities: Introduction

In general, small business ownership offers individuals a unique opportunity to be relatively independent and at the same time realize a profit from his investment and enterprise. By the same token, it is recognized that in owning and operating a small business there is always a risk of failure due to unanticipated changes in the economic environment or market place, as well as problems associated with the management and financial structure of the enterprise.

It is therefore important for small business owners to recognize and understand the major factors that are typically associated with business failures. Based on this knowledge and information, business owners can formulate management, marketing and financial strategies to minimize the risk of failure and maximize profitability and success.

1. Management Factors

Studies have repeatedly shown that many small businesses fail because of inadequate management practices. There are a number of reasons for this situation.

First, many individuals who decide to become business owners have had little formal training or experience in management. Thus, they are engaged in a double learning curve: (1) starting up a new business enterprise, and (2) learning business management on-the-job.

Second, entrepreneurs by definition are generally highly independent individuals who prefer to control all of the major decisions and functions of a business enterprise. Problems arise when a business begins to expand and become more complex, and the entrepreneur is unwilling to change management styles, i.e., building in a division of labor and delegating certain functions and authority.

The combined effects of low management experience levels and an inflexible management style can create serious difficulties for a small business operation.

2. Financial Factors

In effectively operating a small business, the owner/operator must be able to handle a broad range of financial management functions including the cash flow process, accounts receivable, credit terms, credit policies, inventory and sales. As such there is a host of critical decisions and actions that are linked to the financial management of a small business enterprise.

There is no one single factor or set of factors that can lead to major financial problems. However, experience with small businesses has shown a general pattern that offers some insight into the major areas that small business owners should be especially alert to in their operations.

First, the inappropriate planning and management of the business cash flow can result in serious shortages and difficulties in handling debts and other fixed costs. One common mistake is to confuse sales with cash flow given the lag that exists between the point of sale and receipt of actual money. Thus, it is important that a business have sound understanding of the monthly cash flow demands on the enterprise, and anticipate possible shortages that may require an injection of cash through borrowing or deferred expenditures.

Second, at times small business owners may rely on intuitive methods to handle their financial management processes thus basing key decisions on generalized or subjective impressions. In contrast, financial management decisions should also be based on some hard, quantitative information that provides the small business owner with an objective basis for making financial judgments. Unfortunately, when the financial problems reach a critical point there may not be sufficient time to recover since alternative courses of action had not been mapped out in anticipation of these contingencies.

Third, in some cases financial difficulties may simply be the result of poor judgment in making decisions about major investments of capital or purchasing of equipment. Moreover, timing in relation to cash flow, for example, is an important variable within the decision-making equation.

Finally, problems can arise when a business does not have adequate financial systems and controls, together with weak accounting practices that result in the improper handling of cash, bank deposits, petty cash funds, accounts payable/receivable, credit or billing.

3. Economic Factors

Unfortunately, a small company has little control over larger economic forces. For example, changes in external economic

conditions can have an immediate effect on a small business in the form of lower sales receipts, shifts in consumer preferences and purchasing patterns, and tighter controls on commercial/bank credit.

Such economic shifts can be especially perilous for small businesses that are already operating under marginal conditions in terms of their management and finances.

TEACHING AIDS

EXHIBIT 1
GROUP PROCESS FRAMEWORK/BUSINESS FAILURE FACTORS
Survival Strategies

TRAINER'S GUIDE

SESSION:	CASE STUDY ANALYSIS
Module A:	Case Study Analysis
Groups A & B:	
Total Time:	3 hours

A. Teaching Objectives

1. Provide participants with an opportunity to apply the information and techniques presented during the course in analyzing specific small business/lender situations.

2. Enable participants to examine alternative solutions to small business management and/or lending problems.

3. Provide the lenders and borrowers with an opportunity to better understand each others perspectives in coping with management and lending situations.

B. Suggested Teaching Techniques

DAY ONE

During the morning introduction, inform participants that they will be asked to create a "case study" later that week that illustrates some of the typical problems and issues faced by both lenders and borrowers. This case study is intended to provide participants with some concrete situations involving such things as the loan application process, small business management, banker/lender problems and similar types of topics.

DAY TWO

In introducing the exercise, explain to the participants that each group will be exchanging case studies. Thus, the case study situation created by Group A will be given later to Group C for their analysis exercise, and so forth. Thus, each group should strive to be creative and provide their colleagues with an interesting and challenging situation. The case study product does not have to be overly lengthy, but it should contain enough information and detail to permit a thoughtful analysis.

THEY SHOULD MAKE SURE THAT THEIR WRITING IS CLEAR AND LEGIBLE.

The trainer will assign four working groups (two banker groups and two borrower groups) that will be instructed to spend sometime that evening constructing a case study based on the following topics. Four case studies should be created as follows:

Group A (Lenders)	Lender/Borrower Communications
Group B (Lenders)	Problem Loan Application
Group C (Borrowers)	Business Management Problems
Group D (Borrowers)	Financial Management Problems

Each group will be responsible for scheduling its evening work session and producing a brief, but creative, case study problem that can be used by another group as part of an analytical exercise. The case study should follow a standard format that will be supplied by the trainers.

DAY THREE

The trainers should collect the four group products on the morning of the third training day (if possible, before the training day begins). Start the training session that morning by introducing the objectives of the case study.

Use the same groups that were used earlier to produce the case study situations. However, in assigning the case study topics use the following combination as a guide in making the exchange of case studies.

Group A-----Group D
Group B-----Group C

Allow the groups about 90 minutes to work on their respective case studies. Use the remaining 90 minutes for their presentations to the large group and for processing the results.

CASE STUDY FORMAT

Problem/Topic:_____

Group: A__ B__ C__ D__ Borrowers__ Lenders__

Date_____

1. Describe organization/institution in general terms (name, type, history, size).

2. Describe the key actors/individuals involved in scenario.

3. Provide some hypothetical data that can be used by a group to analyze the problem/situation and formulate alternative solutions (e.g., financial information, loan application data, etc.)

4. Describe in some detail the specific problems and factors that characterize this case study situation.

5. Describe any conditions, antecedents or factors that need to be weighed in analyzing the problem and in formulating solutions.