MICROFINANCE CENTRE

SMALL BUSINESS FINANCIAL HEALTH SCORECARD

A METHODOLOGICAL NOTE

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SUMMARY

THIS PAPER PRESENTS THE CONCEPT OF FINANCIAL HEALTH FOR SMALL BUSINESSES AND DESCRIBES THE MFC'S APPROACH TO CONSTRUCTING A COMPREHENSIVE MEASURE OF FINANCIAL HEALTH. FIRST, THE PAPER ARGUES FOR THE NEED TO DEVELOP A MEASURE OF FINANCIAL HEALTH FOR A SMALL BUSINESS THAT GOES BEYOND TRADITIONAL BALANCE SHEET AND INCOME STATEMENT-BASED FINANCIAL INDICATORS. NEXT, THE PAPER CONSOLIDATES EMERGING UNDERSTANDING OF WHAT FINANCIAL HEALTH MEANS, AND PROPOSES A NEW DEFINITION THAT CAPTURES KEY DIMENSIONS OF FINANCIAL HEALTH. THIS IS FOLLOWED BY A DISCUSSION ON THE CONSTRUCTION OF THE INDICATORS AND THE METHODOLOGICAL APPROACH ADAPTED FOR COLLECTING DATA, WHICH IS BASED ON "RULES OF THUMB" RATHER THAN FINANCIAL INDICATORS. THE PAPER ENDS WITH THE DISCUSSION OF THE PROPOSED METHODOLOGY AND ITS FIELD APPLICATIONS.

INTRODUCTION

"Financial health" is an increasingly popular term that describes the state of one's personal financial situation. It encompasses many dimensions, including the amount of savings one has, how much one is putting away for retirement and how much of one's income is spent on various types of expenses. In a sense, the idea of financial health mirrors the concept of physical health, inasmuch as it describes a state of being free from "illness" (e.g. running out of financial resources and entering a state of financial vulnerability). Financial health is not a binary construct of healthy vs. not healthy—rather it is a broad spectrum of possible states that describe the extent or quality of one's financial position or vulnerability.

While defining financial health for a person or a family (or household) is conceptually clear (although not without methodological challenges associated with measurement and interpretation), when applied to businesses the term poses a greater challenge. To accurately evaluate the financial health and long-term sustainability of a company, a number of financial metrics must be considered—coupled with additional indicators relating to stability and potential that influence the financial health of a firm.

FINANCIAL HEALTH OF A SMALL FIRM: FINANCIAL INDICATORS AND MORE

Traditionally, the financial health of a business is assessed by four primary areas of financial activity: liquidity, solvency, profitability and operating efficiency. Of the four, the best measurement of a company's health is likely the level of its profitability—although when it comes to small businesses, short-term profitability may be less important than liquidity ("cash is king" remains a mantra for small businesses and entrepreneurs).

In traditional financial analysis, there are a number of financial ratios that help gauge a company's overall financial health and determine the likelihood of the company's survival. Some absolute value indicators (such as total debt or net profit) are less meaningful than financial ratios that derive from a company's balance sheet or income statement. The general trend of financial ratios (whether or not they are improving over time) is also an important consideration.

While financial indicators remain the core measures of financial health of a company, there are others to consider. Small business financial health goes beyond profitability, and includes other aspects of the organisation's activities and the context in which it operates, such as stability and revenue potential. Although it is nearly impossible to operate a financially healthy small business without a solid underlying business activity, it is possible to have a functional business operating in an unhealthy way. In the case of the latter, traditional financial indicators alone would not reveal these underlying problems, as they focus narrowly on financial success.

TOWARDS A DEFINITION OF SMALL BUSINESS FINANCIAL HEALTH

As a new concept, "financial health" still lacks a universal working definition. "Health", more generally, encompasses physical, mental and social well-being—and is a resource for living a full life. It refers not only to the absence of disease, but the ability to recover from temporary illness and other problems. Factors that influence health include genetics, the environment, relationships and education.[1] Similarly, financial health is a multidimensional phenomenon, with different factors influencing its quality.

The Financial Health Network (FHN),[2] the leading organisation focused on measuring financial health of individuals and small businesses in the US, defines[3] "financial health" as a situation whereby the daily systems of a small business help it build resilience and take grasp opportunities. This fairly intuitive definition combines two important aspects of financial health: the ability to withstand adverse conditions and survive tough times, and the ability to grow and expand in response to market opportunities. Further, FHN clarifies that a small business is financially healthy when it adequately manages its financial matters and maintains financial systems, plans its cash flow and takes measures to protect against risk, and has access to various types of financial resources (see Figure 1).

FIGURE 1: THE FINANCIAL HEALTH OF A SMALL BUSINESS

MANAGES

- Meets financial obligations
- Maintains sufficient cash reserves
- Maintains a comprehensive financial management system

PLANS

- Plans for significant business risks
- Plans for cash flow variability
- Has appropriate insurance

CAPITAL

- Has access to affordable, timely credit
- Has a sustainable debt load
- Has access to investment capital

SOURCE: FINANCIAL HEALTH NETWORK (2019) "A GUIDE TO MEASURING SMALL BUSINESS FINANCIAL HEALTH"

1. WWW.MEDICALNEWSTODAY.COM/ARTICLES/150999.PHP
2. FORMERLY THE CENTER FOR FINANCIAL SERVICES INNOVATION
3. FINANCIAL HEALTH NETWORK (2019) "A GUIDE TO MEASURING SMALL BUSINESS FINANCIAL HEALTH"

In this context, financial health is a desirable outcome or objective for a small business; it is a forward-looking measure that indicates a firm's ability to survive and grow—although it is descriptive not predictive (of the likelihood of that survival and growth). However, as a general rule, we should assume that a financially healthy business, all other things being equal, will have more capacity to survive than an unhealthy one. This conjecture, of course, is open to empirical testing and validation.

THE IMPORTANCE OF TRACKING FINANCIAL HEALTH

Tracking the financial health of a small business is important for various stakeholders, including:

- For **business owners and entrepreneurs**, it provides a more comprehensive picture of the company's standing beyond simple financial ratios—which in the case of a small business do not always adequately represent the financial standing of the firm.
- For **lenders**, it provides a richer perspective to inform lending decisions and helps overcome informational asymmetry, as small businesses remain informationally opaque to external investors and debt providers.
- For **local communities**, financial health indicators provide a snapshot of the state of their small businesses and their resilience and growth potential, and consequently the health of the local economy.
- For **policy makers**, financial health information means developing better policies to support an enabling environment for small business development.

THE MFC SMALL BUSINESS FINANCIAL HEALTH SCORECARD: AN OVERVIEW

The MFC's definition of financial health for a small business draws upon the FHN's definition and expands its scope to include (in addition to core financial indicators), access to finance and financial management capabilities, factors related to business stability, and revenue potential (see Figure 2).

FIGURE 2: COMPONENTS OF THE MFC FINANCIAL HEALTH SCORECARD

From this perspective, the MFC's Financial Health Scorecard is a system of indicators organised into two main dimensions, both superimposed over the general financial standing of a firm:

- Financial: The ability of a small business to access capital when needed on reasonable terms and conditions, and its ability to successfully manage its finances
- Operational: The ability of a small business to survive or grow in their particular market conditions and generate revenue.

The indicators and measures of financial health applied in the scorecard are constructed as intuitive measures, taking into account that small businesses do not have adequate and consistent formal financial records, and small business owners are often financially unsophisticated and therefore unable to respond to survey questions that use financial jargon and technical terms. This approach is consistent with the recent literature on the use of "rules of thumb" when dealing with small businesses,[4] which appears to produce satisfactory results in the face of incomplete information.

FINANCIAL STANDING (FS)

Financial standing refers to the general financial condition of a small business, and captures aspects such as business revenue (and whether it is higher or lower in relation to the previous year), the ability to cover the running costs of a business, reliance on external debt, unused or idle inventory, and delays in making scheduled payments.

ACCESS TO FINANCE (AF)

The access to finance component considers the ability of the business to access external funding when needed. The questions in this section include the loan repayment history of the business, its ability to borrow emergency funds, and its ability to access growth funding from formal financial institutions.

FINANCIAL MANAGEMENT (FM)

The financial management section explores a business' ability to manage funds and keep appropriate financial records on par with its business needs. Questions for this indicator consider the existence of a record-keeping system, whether expense records are kept, separating business and personal financial records, use of non-business income to cover the running costs of the business in times of low revenue, the ability to payments on time, and the owner's perception of control over the financial situation of the business.

STABILITY AND SURVIVAL (SS)

The stability and survival section tracks the firm's ability to stay in business through unexpected market events, and as such is a proxy for business resilience. Questions in this section include the owner's perception of the stability of their business, the ability to rebound from a loss of a major customer, the ability to operate a business without a sudden loss of revenue, the ability to make an investment purchase from current revenue or savings, insurance against risks, and whether it faces delays in receiving payments from customers.

4. See, for example, Alejandro Drexler, Greg Fischer, and Antoinette Schoar (2014) "Keeping it Simple: Financial Literacy and Rules of Thumb, American Economic Journal: Applied Economics", Vol. 6(2): pp 1–31 (http://dx.doi.org/10.1257/app.6.2.1.)

REVENUE POTENTIAL (RP)

The revenue potential section interrogates the firm's market position and potential of the market segment in which the business is operating. Questions in this section include the revenue potential of the business in the medium term, its search for new business opportunities and the business owner's perception of the competition in the market.

FINANCIAL HEALTH SCORES

The Financial Heath Scorecard creates a Composite Financial Health Score (CFHS), which is calculated as an average of the five category scores described in the previous section:

$$CFHS = \frac{(FS+AF+FM+SS+RP)}{5}$$

Whereby:

Composite FHS = Composite financial health score of a business
FS = Financial standing score
AF = Access to finance score
FM = Financial management score
SS = Stability and survival score
RP = revenue potential score

The CFHS is normalised and measured on a 100-point scale for ease of interpretation of the results. The following scale is proposed for interpreting the CFHS score that can fall into one of the four grade levels (see Table 1).

TABLE 1: COMPOSITE FINANCIAL HEALTH SCORES

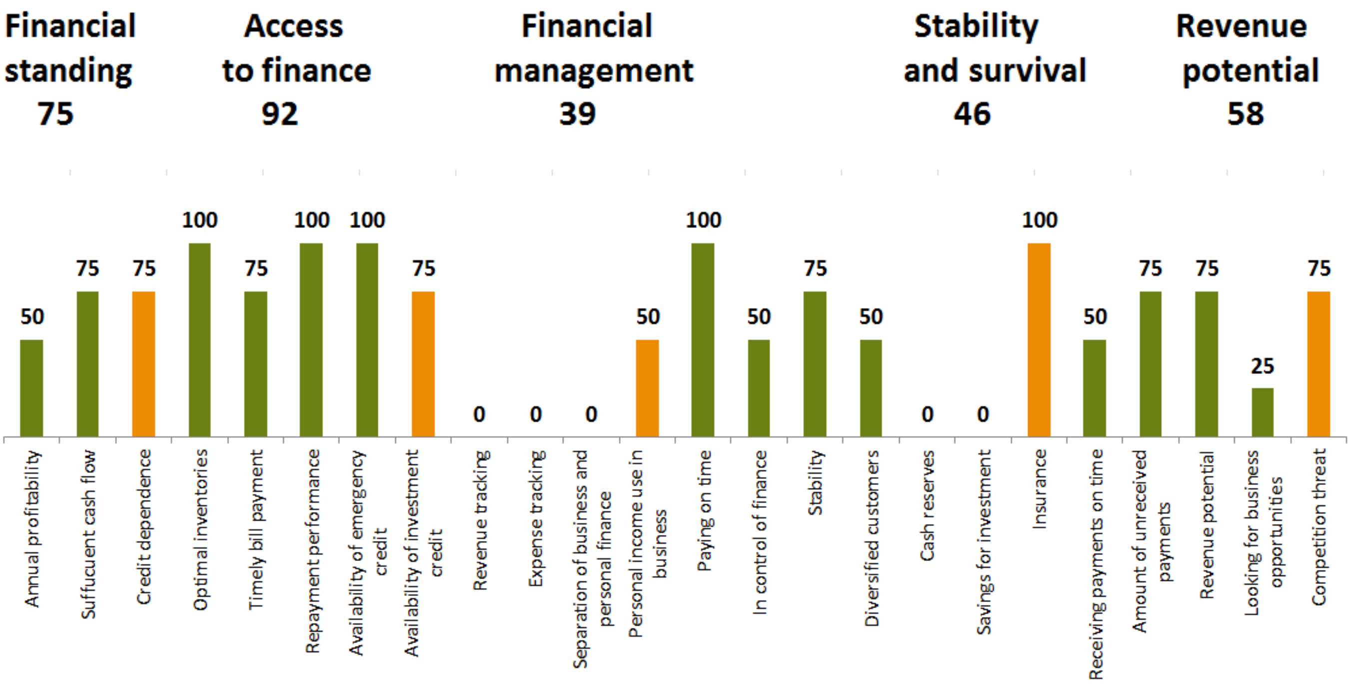
CFHS SCORE	GRADE	DESCRIPTION
75–100	Excellent	A firm shows high levels of financial stability and market resilience, it appears to be financially well-managed and has a solid market position.
50–74	Good	A firm enjoys good financial health that offers substantial cushion against unpredicted events, but there are elements which could be improved.
25–49	Poor	A firm is in poor financial condition that may be a result of weak financial indicators, poor financial management, or market conditions.
0–24	Unhealthy	A firm is financially unhealthy and should embark on a program to improve its financial and market situation as it is survival may be at risk in the short or medium term.

TABLE 2: SAMPLE FINANCIAL HEALTH SCORES AND COMPOSITE SCORE

	MAX	MIN	AVERAGE SCORE
FS	100	50	75
AF	100	75	92
FM	100	0	39
SS	100	0	46
RP	75	25	58
CFHS			57

As Table 2 shows, a company can be graded as having good financial health with a Composite FHS of 57. Yet Figure 3 demonstrates that the result of a company is excellent in access to finance (AF) and financial standing (FS), yet with poor financial management (FM) and low stability and survival (SS) score that pulls down the overall CFHS grade. The remaining category – revenue potential (RP) – registers a good score. This example illustrates the earlier point that financial health is a multidimensional concept that needs to be measured by several indicators in order to accurately depict a firm's financial health.

FIGURE 3: SAMPLE SCORES BY CATEGORY AND INDICATOR



GUIDELINES FOR FIELD APPLICATION

A business can easily apply the Composite FHS method by answering 24 questions using an online survey that calculates the overall score. The resulting report helps the entrepreneur to understand the underlying reasons for the score and to identify areas of weakness and strengths. The tool also compares the company's results with best practice standards in business management.

The Composite FHS method can also be used by lenders (microfinance institutions and banks) to gain a broader insight into the business, one that is not solely based on financial analysis. It may also be of use to business advisors and consultants as a preliminary tool to assess the financial condition of a business.

In addition to producing the consolidated financial health score, an MFI can use the tool to analyse clients' financial health by category in order to identify weaknesses—as illustrated by the following example of hypothetical small business (with average scores shown in Table 2).

SUMMARY AND CONCLUSION

The Financial Health Scorecard is an attempt to quantify the financial health of a small business—in other words, the extent to which its daily systems help it build resilience and grasp opportunities. By answering a series of standardised, common-sense questions related to their business, owners and managers can get a snapshot of the financial health of their company, and can identify their operational strengths and weaknesses by analysing by category, and indicators within those categories. Overall, the Composite Financial Health Score (and its category scores) can provide a high-level forward-looking assessment of a firm's ability to withstand adverse market and financial conditions and explore opportunities for growth.

The reliability of the instrument and the validity of the resulting scores need to be field tested to ensure that the methodology adequately captures all salient features of a small business, and that instrument (which is based on a rule-of-thumb approach to assessing the financial health) produces robust results that can be used as a proxy for missing or incomplete financial and market data for a small business. This can be a subject for future research.

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THE MICROFINANCE CENTRE IS A SOCIAL FINANCE NETWORK THAT PROMOTES FAIRNESS, INCLUSION, EQUALITY AND RESPONSIBLE SERVICE.

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