

Financial Performance - The Key to Survival

Our culture revolves around statistics. In baseball there are statistics for the total number of bases a batter achieves versus his batting average. In cinema, the second week of a film's run is a more important factor in determining its long term success than the first. And in farming a high per acre crop yield is more important than the total bushels harvested.

All these statistics relate in one way or another in determining how well we do. They are the measuring sticks of life. Business use them; governments use them; churches use them; non-profit organizations use them. The most widely used statistic or measuring stick is the financial statement.

Financial statements are the measuring stick for success or failure in business. They provide management with the ability to measure their success or failure. The value of a company is measured by its financial resources and ability to generate income. Financial statements are tools we use to buy or sell a business, to purchase stock of a business listed on the stock exchange, and to validate our income and expenses in our non-profit organization or church. Financial statements are the single largest resource used by bankers to determine if they should lend money to a prospective customer. The federal and state governments use our financial statements to assess taxes.

Within a company, financial statements are the most accurate record of performance and one of the most helpful tools to management, if they are used correctly. Financial statements can help management determine if profit targets are being met, if cash flow is adequate, if long range objectives are being achieved; and they provide a backbone for predicting the future. In short, if management uses their monthly financial statements as a resource and management tool, it usually determines the difference between failure and doom.

The Key Components of a Financial Statement

The most important element of a financial statement is the balance sheet. The balance sheet provides a picture, a literal snap shot, of the financial health at a given time in a company's history. The balance sheet is composed of three primary segments: Assets, Liabilities and Net Worth (stockholders equity). Think of a balance sheet as a teeter totter, the only difference is there is one person on onside and two people on the other side and it always is in balance. The one person by themselves could be considered the assets: the total funds invested in the business and the other side. The liabilities are the fund supplied to the business by its creditors and Net Worth is funds supplied to the business by its owners. Debra, if you can think of a better way to picture this, give it a try.

The balance sheet has been standardized by the accounting profession and essentially all basically contain the same categories. You can pick up a balance sheet of General Motors and one from your local grocer and each will have assets, liabilities and net worth.

The assets in a balance sheet are arranged in decreasing order of how quickly they can be turned into cash (liquidity). That is why Cash is always first, accounts receivable second, inventory third and so on. The liabilities are listed in order of how soon they must be repaid. In this fashion, accounts payable usually top the list, other payable, taxes payable, bank note payable, mortgages and so on. Net worth is defined by a number of categories depicting what type of funds are invested by the owners or stockholders.

In more detail these are:

1. Assets - This includes current assets: cash, accounts receivable and inventory; fixed assets: land, buildings, equipment, machinery, furniture; and other assets patents, trade marks, and money due from others (accounts or notes receivable).
2. Liabilities - This includes funds acquired for a business through loans or the sale of property or services to the business on credit. Creditors do not acquire business ownership but hold promissory notes that are to be paid at a designated future date. Liabilities are defined as either current liabilities, payable within a year or long term, liabilities with maturities longer than a year. Current liabilities would include accounts payable, notes payable, taxes payables, salaries payable, and the current portion of long term debt. Long term debt would include mortgages payable, notes payable and any other obligation or money due to a creditor.
3. Shareholders' equity (net worth). This is money put into a business by its owners for use by the business in acquiring assets. Money can flow into equity through common stock, preferred stock, retained earnings (profit earned by the company in prior years) and current earnings, all total the net worth. Deductions to net worth would include treasury stock and dividends.

Your financial balance

The balance sheet is an excellent tool, management tool, for keeping you in tune with the financial balance or financial imbalance of your business or organization. This financial balance has cash flow and profit implications, which can greatly benefit or hinder the businessman. Entrepreneurs usually start their companies with a little bit of money, usually not enough. The overwhelming share of owner's equity, though, comes from that powerful source-retained earnings. During the history of the business, there needs to be a reasonable balance between the proportion of owners (stockholders) money in the business (net worth) and others people's (liabilities). There isn't a precise, scientifically derived cutoff point between financial balance and financial imbalance, but there is an approximate point and its impact is really and immediate.

The best way to determine this point is through a ratio called the debt to worth ratio. It measures the relationship between liabilities (others people's money) to net worth (owners/stockholders money). This ratio is calculated by dividing the total liabilities by the total equity (common stock + retained earnings + current year earnings). Example, if the company had \$350,000 in liabilities and \$100,000 in net worth the company would

have a 3.5 to 1 debt to equity ratio or for every dollar the owners had invested in the business, the other people have \$3.50 loaned to the business. Determining the adequacy or inadequacy of this debt to worth relationship is not simple and is based on the historical performance of the company, the type of industry, the owner's own net worth and the concrete prospects that company has for profitable operations in the immediate future.

Consequently, for entrepreneurs to be able to manage the financial balance of their own businesses, they will have to be able to analyze their own financial statements and be able to evaluate those results in the light of some good business planning. This is particularly important due to the fact that the great cause of business failures is financially related. An article in the spring issue of Journal of Management Consulting, detailed the nine most commonly cited causes of small business failure. They are as follows:

- 1) lack of financial planning,
- 2) absence of business records,
- 3) no understanding or use of business records,
- 4) poor cash-flow management,
- 5) poor inventory management,
- 6) poor costing or pricing,
- 7) poor market research,
- 8) poor inventory management and
- 9) over borrowing.

The balance sheet is also the great resource of information in determine what needs to happen to increase cash flow in the business. The effective utilization of all assets: accounts receivable, inventory and fixed assets, is paramount to maximizing cash flow in the business. With information detailed in the balance sheet and a profit and loss statement, a business can measure the effective utilization of their investment in these key assets that directly affect cash flow.

By Dan Lacy