

Watch the Balance Sheet!

Business performance hinges on your ability to analyze financial statements.

Our culture revolves around statistics. In baseball, the number of bases a batter crosses in a season is compared to his batting average. In cinema rating, the second week of a film’s run is more important in forecasting its long-term success than the first. And in farming, a higher per-acre crop yield is more important than the total bushels harvested.

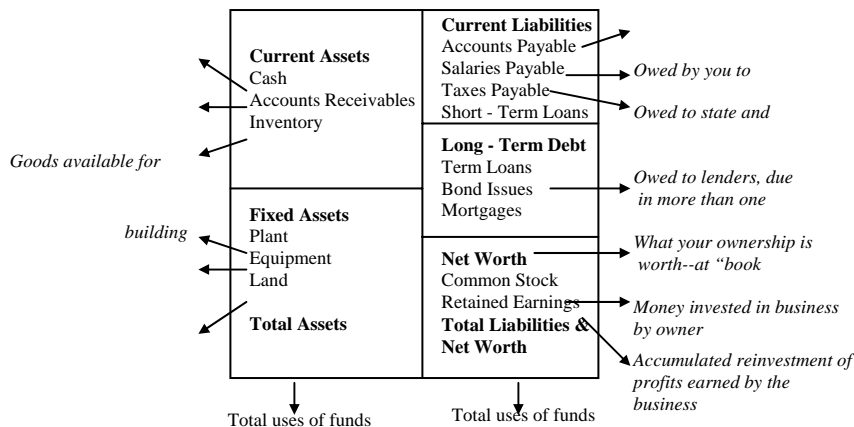
Obviously, statistical comparisons help us determine how well we are doing. They are the measuring sticks of life. Businesses use them, governments use them, churches use them, non-profit organizations use them. In business, the most widely used statistic is the financial statement.

Financial statements are the measuring sticks for success or failure in business. Smart managers know this and are able to make good use of the information found on a financial statement.

Within a company, financial statements are the most accurate record of performance and are, therefore, one of the most helpful management tools—if 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 on time. They provide a backbone for predicting the future. In short, when management uses monthly financial statements as a resource and tool, it can usually foresee or even prevent the company’s failure.

THE BALANCE SHEET

The most important element of a financial statement is the balance sheet. The balance sheet provides a picture—a literal snapshot—of the financial condition at a given time in a company’s history.



A balance sheet is better understood by focusing on the “balance” idea. It has three components: one on the left side of the fulcrum and two on the right side. The component on the left side is called “assets,” the total funds invested in the business. The two components on the right side are “liabilities” and “capital.”

Liabilities are the funds supplied to the business by its creditors. Capital is the funds supplied to the business by its owners. The assets side should always be in balance with the liabilities and

capital. For example, when product is purchased for resale, inventory increases on the assets side of the balance sheet and accounts payable increases on the liability side.

The balance sheet has been standardized by the accounting profession to contain mostly the same categories. You can pick up a balance sheet from General Motors and one from your local grocer and both will have assets, liabilities and capital.

The assets on a balance sheet are arranged in decreasing order, depending on 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. Accounts payable usually top the list, followed by other payables, taxes payable, bank note payable, mortgages, etc. Capital is defined by a number of categories depicting the type of funds that are invested by the owners of stockholders.

YOUR FINANCIAL BALANCE

The balance sheet is an excellent management tool for keeping you in touch with the financial balance or financial imbalance of your business or organization. This financial balance has crucial cash flow and profit implications that can greatly benefit or hinder the businessman.

Entrepreneurs usually start their companies with a relatively small amount of money, usually not enough. The overwhelming share of owner's equity though, comes from a 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 (capital) and other peoples' money (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 real and immediate.

The best way to determine this point is with the "debt-to-worth ratio." It measures the relationship between liabilities (other peoples' money) and capital (owners/stockholders' money). This ratio is calculated by dividing the total liabilities by the total equity (common stock, plus retained earnings, plus current year earnings). For example, if the company has \$350,000 in liabilities and \$100,000 in capital, it has 3.5 to 1 debt-to-equity (capital) ratio. This means for every \$1 the owners have 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 capital and the concrete prospects the company has for profitable operation in the immediate future.

For most closely held businesses, the ratio should be somewhere between 4.0 to 1 and 1.5 to 1. A business that has maintained consistent profitability over the last few years can have a higher debt to worth ratio than a business that has erratic or low profitability.

The balance sheet is also a great source of information when determining how to increase a business' cash flow. The effective use of all assets—accounts receivable, inventory and fixed assets—is paramount to maximizing available money. With detailed information from the balance sheet and a profit and loss statement, a business can measure the effectiveness of its investment in the key assets that directly affect its cash flow.

OTHER WAYS TO ANALYZE

Before using your balance sheet to pinpoint additional problems, gather up your last three years of financial statements and a projected year-end balance sheet for the current year. Then take the following three steps:

1. Calculate the debt-to-worth ratio for each year and determine whether the ratio is getting bigger or smaller. If bigger, figure out why and make some changes to correct the problem. It needs to be getting smaller.
2. Review your investment in accounts receivable. Is the investment in this asset growing at the same rate as sales? Slower? Faster? Retailers won't have a heavy investment in accounts receivable, but for those businesses that do, a faster growth in accounts receivable as compared with sales will deplete cash flow.
3. Review your investment in inventory. For businesses in retail or wholesale, this will be a key line item to review. As with accounts receivable, the amount of inventory on hand needs to relate directly to sales. If sales in the business have been growing at a rate of 12 percent over the last three years, at what rate has the investment in inventory been growing? If the investment in inventory is growing much faster than the growth of sales, this will negatively affect cash flow. If it has been growing slower than sales, it could positively affect cash flow.

REVERSING PROBLEMS EARLY

To ignore the information available on a balance sheet is detrimental to a businesses financial health. Many of these problems can be reversed early enough by analyzing financial statements. For entrepreneurs to be able to manage the financial balance of their own business, they will have to be able to analyze their own financial statements and be able to evaluate those figures in light of some good business planning.

By Dan Lacy