The Clues Are In The Balance Sheet

Here it is the 10th of the month and your bookkeeper trots into your office with financial statement in hand. She's got that big grin on her face—not because she knows whether the news she's delivering is good or bad but because she got it to you *on time*.

You've already begun to recognize the importance of *timely* financial information. Business is fluid and you need to be able to turn on a dime. You can't make decisions based on information that's thirty to sixty days old. Jason Jennings and Laurence Haughton summed it all up in the title of their book *It's Not the BIG That Eat the Small…It's the FAST That Eat the Slow.* (HarperCollins © 2002)

Let's start delving deeper into your financial statements. I know your first impulse is to go straight to the income statement to see the bottom line, but let's first analyze the Balance Sheet to check the underlying health of your company.

Bankers, finance companies and potential investors will always look first to the Balance Sheet. Sure it's important to have revenues and to be profitable, but savvy finance professionals know that the Income Statement shows a relatively short term picture of the company—a month, a quarter or a year—while the Balance Sheet reflects its history.

Anyone can have a big sale to boost revenues or temporarily slash expenses in order to show profits, but that doesn't necessarily prove long-term sustainability. By contrast, the Balance Sheet shows the company's ability to pay its bills and meet its obligations. Strong Retained Earnings indicates on-going profitability through the years.

Your Balance Sheet includes your assets—what you **own**—your liabilities—what you **owe**—and your Stockholder's Equity—the sum of your initial investment, your stock, and your retained earnings.

Assets include cash, accounts receivable, inventory, store fixtures and improvements, real estate owned by the company, vehicles, and any marketable securities that you may have. Current assets are those which you will probably turn into cash within the coming year—cash, inventory, accounts receivable, pre-paid expenses and short term securities. Fixed assets are those you purchase to use in the operation of your business and that you keep for a longer period such as computers, fixtures, and trucks.

If you want to have information that you can use in managing your business, you have to be honest with yourself. Remember that receiver in the back that you've used for scavenging parts? How about the sewing machine you took back after it had been in the customer's home for six months? Should those things really be included in your inventory?

Same thing with your accounts receivable. If you're never going to collect the $2,800 from the contractor who filed bankruptcy, it's probably no longer an asset and should be written off.

Dealers avoid write-offs to dodge the negative impact it has on profitability. Writing off a piece of damaged inventory is like ringing up a sale for $0—the cost of the product goes into Cost of Goods Sold, but there's no offsetting revenue. Ouch.

Eventually you've got to face those back-room demons and balance sheet skeletons if you're really going to know the true state of your business.

The more accurately you value your assets, the better picture you'll have of your company. You'll be better able to make changes and set direction.

Liabilities include any debt you will have to pay like floor plan, leases, accounts payable and accrued sales and payroll taxes. Current liabilities are those that will have to be paid within a year including your floor plan balance, your accounts payable, the next twelve payments on your vehicles or building leases and your taxes.

Long term liabilities include the non-current portion of bank loans and leases, and loans from shareholders.

My head is hurting! What do all those numbers mean? If you start to understand a few key ratios, you'll quickly discover how your Balance Sheet works.

Liquidity Ratios show your ability to meet your current obligations. The first is the Current Ratio. To compute it, divide your Current Assets by your Current Liabilities. If your Current Assets are $763,333 and your Current Liabilities are $455,475 the math is 763,333/455,475 which is 1.68. That means you have $1.68 in available Current Assets to pay each $1 in current bills. A stretch goal would be to have a Current Ratio of 2:1, $2 in Current Assets for each $1 of Current Liabilities.

The Quick Ratio gives you a better idea of your cash position and is computed by dividing your Current Assets minus you Inventory by your Current Liabilities. In our example, if your Current Assets includes $411,330 of Inventory, your formula would be 763,333 - 411,330/455,475= .77. You have 77 cents in Quick Inventory to pay each dollar of Current Liabilities. You'd be more comfortable with a ratio of 1:1.

The best Liquidity test is computed by dividing your Cash by your Current Liabilities. In our example you have $124,003 to pay your $455,475 in Current Liabilities for a Cash Ratio of .27—nearly the same as the average. A Cash Ratio of .50 would make paying bills a lot less stressful.

You can improve the above Liquidity ratios by reducing your accounts payable and increasing cash reserves. At the same time, watch the growth of Fixed Assets if you need to lease them or increase your debt to acquire them.

The Debt-to-Equity Ratio measures the Safety of your company. It compares the amount invested in the business by Creditors (total debt) to the amount invested by the company's owners (total equity). The formula is Total Liabilities/Total Stockholder's Equity. Most lenders are comfortable with a ratio under 3.0.

In the coming months, we'll address other important Balance Sheet Ratios like Inventory Turns and Gross Margin Return on Investment. We'll also look to see how your accounts receivable and fixed assets perform and see other ways to judge the return on your investments.

Start a chart showing the key ratios you compute each month and track the trends. You'll quickly be able to see how inventory levels affect cash and how quickly collecting your receivables is critical in managing your assets. You'll learn that the twenty or thirty minutes you spend analyzing your financial statements each month can define your success.