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Knowing Where You Stand is Essential during Downturn

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A mistake many small-business owners make — especially when the economy is on solid ground and a business seems healthy — is failing to monitor their financial position. Such neglect can have catastrophic consequences in times like these, when orders are falling and money is tight.

To see where your business stands, start with your financial statements. All businesses should have monthly or quarterly financial statements prepared by a bookkeeper or accountant. Waiting until the end of the year when reports are needed by the IRS or a lender robs you of an opportunity to make midyear corrections if the numbers warrant it.

Financial statements consist of the balance sheet and income statement, also called the profit and loss statement or statement of revenue and expenses. A third element, the statement of cash flow, should also be compiled.

The statement typically overlooked by small-business owners is the balance sheet, which offers a snapshot of the business's health. The balance sheet should be reviewed before you buy equipment, hire employees, expand the customer base, extend credit or initiate advertising. It's a daily account of the business's assets and liabilities and the owner's equity transactions.

The first section of the balance sheet focuses on assets, the things a business owns. Assets include cash, equipment, land, inventory, accounts receivable, patents and vehicles. On the balance sheet, the most liquid assets – those easiest to convert to cash — are listed first.

The second section lists liabilities or what a business owes. Liabilities include bills (accounts payable), taxes due, salaries and wages, interest and other debts or notes. They can be formal, such as a promissory note or loan contract, or as informal as an oral agreement to pay for supplies in the future.

The third section indicates the ownership interest, known as owner's equity or net worth. Net worth increases when cash is injected into the business either by profits or by the owner's investment. It decreases when the owner takes money out of the business or when expenses accrue. The balance sheet should be compared against previous balance sheets to ensure that net worth is increasing.

Financial ratios can also be used to expose potential problems in time to solve them. The current ratio determines liquidity or the ability of current assets to cover current liabilities. “Current” refers to items that will convert to cash or be paid within a year. Current ratio is computed by dividing current assets by current liabilities. If the ratio is 1.30, it means the business has $1.30 to pay for every $1.00 in current liabilities. If the ratio drops below 1.00, it means the business cannot fulfill its short-term obligations using its assets. While a low current ratio does not mean the business is doomed, it is a warning to take seriously.

Debt-to-equity ratio is an indicator of debt load. To compute a business’s debt-to-equity ratio, divide total liabilities by the owner’s equity. For example, if total liabilities are $800,000 and the owner’s equity is $325,000, the ratio is 2.46. This means that for every $1 the owner has contributed, creditors have contributed $2.46. This debt-to-equity ratio may be too high and the owner might consider investing more capital.

A balance sheet’s financial ratios can help you catch problems with your business before they get out of hand. Compare you own business from one month to another and from year to year, and compare it with other businesses in your industry. Using the financial tools at your fingertips ensures you won’t be surprised at the end of the year.

For more information, contact the Small Business Development Center in your region.

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