Excerpted from
FastTrac® GrowthVenture™

TAKE CHARGE OF YOUR BUSINESS®

A program of the Kauffman Foundation

Evaluate Performance: Balance Sheet

Financial statements and reports must be read together to learn the whole financial story. For example, an Income Statement may report a large sale to a new customer, while the Balance Sheet shows the sale as an Accounts Receivable. Reading an aging receivables report may reveal that the account has been unpaid for quite some time. Reading all of a company's statements and reports deepens your understanding of this financial story.

The Balance Sheet Tells the Rest of the Story – The Balance Sheet will help you understand your financial story's setting and characters and how they work together to achieve the story's end—profitability. The Balance Sheet identifies the means available to make those profits repeat and grow in future years. Using this year's Balance Sheet, you will have a better idea of how to plot next year's profitability story and what your future business wealth will be. To use this tool effectively and improve your financial performance, you need to evaluate the major Balance Sheet components – Assets, Liabilities, and Equity.

Assets

Assets, such as cash, equipment, and property, are owned by the company for one reason—to increase the business's profitability and future wealth. One way to look at the effectiveness of assets is to evaluate how well they are generating profits by focusing on the Return on Assets (ROA). Look at your own business's ROA trends over time and compare them to industry averages. Since assets are an investment in future profits, ROA should be higher than the rate paid by other conservative investments. It should also be higher than the rate paid for funds borrowed by the business.

Return on Assets compares Net Income and Total Assets to show how much income has been generated from each dollar's worth of the company's assets. Most manufacturing companies are very asset-intensive. They require large, expensive machinery to produce their products. For example, Yamaha® has shown a Return on Asset ratio ranging between 2 and 5 percent for the last few years. Comparing that with Harley-Davidson's impressive ROA of around 18 percent, it is easy to see that companies in the same industry can operate very differently.

Since service companies are usually very asset-light, they can have difficulty using the Return on Assets ratio to effectively evaluate financial performance. Other ratios such as Net Margin and Return on Equity may be more useful indicators for service-based companies. Return on Equity is discussed on pp. 7-8.

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Return on Assets	Year 1	Year 2	Year 3
My Company's Return on Assets			
Industry Return on Assets		**Return on Assets Equation:** $\frac{\text{Net Income}}{\text{Total Assets*}}$	

* If your business experiences large variances in assets during the year, calculate ROA using an average of the assets over the period being evaluated.

The total assets owned by a company will typically remain fairly stable, so an increasing ROA indicates greater profitability while a decreasing ROA indicates less profitability. You have two primary ways to improve the return on your assets—increase Net Income without acquiring new assets or improve the effectiveness of existing assets. Depending on the type of business you have, you'll want to pay particular attention to Accounts Receivable, Inventory, and Fixed Assets when evaluating your ROA.

To improve the effectiveness of your assets, evaluate each asset category to identify room for improvement. For example, one way for companies to improve ROA is to subcontract out some of the process rather than invest in expensive equipment to do the same work. Another way to improve your return on assets is to manage your inventory and collect accounts receivable better and faster.

Managing Inventory

The way your business manages inventory has an impact on both profits and cash flow. When purchased, inventory is an asset recorded on the Balance Sheet. At any given time, assuming a customer wants it, you can sell inventory to regain cash. Once sold, the cost of the inventory items sold is transferred from the Balance Sheet (Inventory account) to the Income Statement (Cost of Goods Sold account). When inventory cannot be sold, it becomes worthless to the business and you should write it off and discard it.

One way to evaluate how well inventory is being managed is to look at the Inventory Turnover ratio. This ratio tells how many times the average level of inventory is sold, or turns over, during the year. The ratio should be used to compare your company's own trends and to compare to the industry's averages. High turnover is generally good. Depending on what you sell, a high turnover rate may be three times a year or 300 times. High turnover, however, may also indicate that there is not enough merchandise, and sales are being lost.

Inventory Turnover	Year 1	Year 2	Year 3
My Company's Inventory Turnover			
Industry Inventory Turnover		**Inventory Turnover Equation:** $\frac{\text{Cost of Goods Sold}}{\text{Inventory*}}$	

* If your business experiences large variances in inventory during the year, calculate Inventory Turnover using an average of the inventory over the period being evaluated.

To manage inventory effectively, you should pay close attention to the value of your inventory and the systems you need to control actual inventory.

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Inventory value – Of course the Inventory Turnover ratio only identifies the number of times the entire inventory is sold during the year. It does not evaluate each element of inventory as it moves through the production cycles. Inventory could include raw materials ready to be produced, goods in production but not yet completed, and completed goods ready to be sold. To effectively manage inventory and the associated costs, you must correctly value the inventory as it progresses through the production cycle. For example, the retail value of a finished wooden garden shed far surpasses the original value of the raw materials used to create the shed. Your CPA, trade association, or business consultant can be of assistance in selecting and designing the appropriate systems to help you value your inventory at various stages in production.

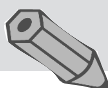
Inventory systems and control – Have you ever used the computer to verify the stock available for a large sale and then run out to the warehouse to check the shelf just to be sure? Any business that sells merchandise must be aware of the actual inventory on hand in order to have just the right amount to sell to customers. Consider this: inventory lost through shrinkage—theft, breakage, and loss—must be covered by profits. In other words, if this sample company's Net Margin is 3 percent, it takes $5,000 in new sales to make up for a $150 inventory loss!

Income Statement

A $5,000 sale provides enough cash to replace $150 of lost inventory.

Sales	$ 5,000	100%
Expenses	4,850	97%
Net Income	$ 150	3%

Even with computer inventory records, your inventory control systems need a physical inventory to verify the computer's totals. Differences may occur because of problems in the inventory control system. Use the following Inventory Management checklist to review several strategies to improve your system of inventory management.



Inventory Management

Put a check next to the inventory management tips you can use in your business to better manage inventory and improve profitability and cash flow:

- Sell older inventory items, even if it means discounting sales prices.
- Reduce the types of raw materials used to cut the costs of storage and to benefit from buying in larger quantities.
- Reduce the amount of raw materials needed on hand.
- Streamline the production process to sell inventory quicker.
- Establish a tighter inventory control system that includes verification of actual stock on-hand.

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Collecting Accounts Receivable

Accounts Receivable describes money due from customers for products or services already sold. In essence, when you extend credit to customers it is like giving them an interest free loan. You should have an effective collection policy to ensure that invoices are sent and cash is collected on these credit sales as quickly as possible.

One way to measure the effectiveness of your collection process is to review the Accounts Receivable Turnover ratio, which measures how many times the average receivable balance turns into cash. A high ratio indicates an efficient collection process. A low or declining ratio reveals a problem within some portion of the credit and collection process. For example, if a business has Accounts Receivable of $145,000 at the end of the year and credit sales of $1.2 million for that same year, the Accounts Receivable turnover ratio is 8.3 times, which means that the average total due in invoices was collected over eight times during the year ($1.2 million / $145,000 = 8.28). If the business allows credit terms of Net/30, they would expect their ratio to be closer to twelve times, which would indicate that invoices are collected every thirty days (365 days in the year divided by 12 months). This business looks like it needs to tighten up their collections process.

Accounts Receivable Turnover	Year 1	Year 2	Year 3
My Company's A/R Turnover			
Industry A/R Turnover		**Accounts Receivable Turnover ratio:**	Annual Credit Sales / Accounts Receivable*

* If your business experiences large variances in Accounts Receivable during the year, calculate this ratio using an average of the Accounts Receivable over the period being evaluated.

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Liabilities

When reading the Balance Sheet as a financial story, you will quickly identify Cash as the hero of the tale. With enough cash, a happy ending seems inevitable. Some entrepreneurs see Liabilities as the villain who is typically at odds with the hero and working behind the scenes to sabotage the business. In your real-life financial story, nothing could be further from the truth. Although not the hero, Liabilities have an important supporting role that is vital to the creation of a healthy cash flow.

The more cash you have and the longer you can hold on to it, the better. One way to secure more cash and other assets is through the proper use of Liabilities. Liabilities are categorized as either short-term or long-term debts, called Current or Long-Term Liabilities.

Current Liabilities

Current Liabilities are bills or loan payments due within the next business cycle, usually a year. The primary Current Liabilities are Accounts Payable, Accrued Expenses, and Short-Term Notes Payable. Accounts Payable are amounts owed to vendors and suppliers who have allowed your business to purchase materials, merchandise, and supplies on credit. Accrued Expenses are normally estimates of future expected payments such as wages, interest, and taxes that have not yet come due. Short-Term Notes Payable are usually interest-bearing debts that have been secured for the purposes of purchasing assets or otherwise supplying cash to operate the business.

Evaluating Your Use of Current Liabilities

Several ratios, called Liquidity ratios, are used to measure a company's ability to pay its short-term bills, also called its liquidity. The two most commonly used ratios are the Current Ratio and the Quick Ratio. The Current Ratio is based on all of the Current Assets and Current Liabilities, and a 2:1 ratio is usually considered ideal. In other words, a business has twice as many Current Assets as it has Current Liabilities. You should compare your own Current Ratio to other companies in your industry to determine your Current Ratio goal. The Apollo Group®, provider of higher education programs for working adults, might have been concerned about their Current Ratio of 1.59 compared to the ideal of 2. Compared to Franklin Covey® at 1.64, however, their ratio looks to be in line with the industry.

The Quick Ratio, also called the *acid test*, determines if you have sufficient cash, receivables, and marketable securities available immediately to pay off current debts. This ratio excludes inventory because it is often difficult to liquidate inventory quickly. Just as gold is tested with nitric acid to determine its quality, potential creditors may use this *acid test* to judge the quality of your business as a potential payer. A 1.0 ratio is usually preferred. If this number is going down, sales are not strong enough to meet daily cash obligations.

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<table>
<tr><th>Liquidity Ratios</th><th>Year 1</th><th>Year 2</th><th>Year 3</th></tr>
<tr><td>My Company’s
❏ Current Ratio</td><td></td><td></td><td></td></tr>
<tr><td>❏ Quick Ratio</td><td></td><td></td><td></td></tr>
<tr><td>Industry
❏ Current Ratio</td><td></td><td colspan="2" rowspan="2">Current Ratio: $\frac{\text{Total Current Assets*}}{\text{Total Current Liabilities}}$

Quick Ratio: $\frac{\text{(Current Assets – Inventory)*}}{\text{Total Current Liabilities}}$</td></tr>
<tr><td>❏ Quick Ratio</td><td></td></tr>
</table>

* If your business experiences large variances in assets, liabilities, and inventory during the year, calculate these ratios using averages for the period being evaluated.

If your liquidity ratios are lower than ideal, assess why your cash supply is weakening and work on appropriate strategies to increase cash flow. This approach will improve your ability to pay your bills in the long-term. During this time, maybe you can refinance and get longer-term loans, or investors could contribute additional cash that could be used to pay off debts. Doing so will ease the current stress on cash.

Long-Term Liabilities

Long-Term Liabilities are debts that will not be repaid until after the current business cycle, which is typically one year. It is healthy for a company to have some long-term debt, especially if the business needs considerable assets to operate. The Debt to Asset ratio measures the extent to which a company is financed with debt. It is important to keep the ratio of debt to asset at a healthy level. Generally, a Debt to Asset Ratio of no more than 50 percent is considered sensible. Having a Debt to Asset ratio of more than 1 is like being upside down in your car loan—you owe more money than the car, or in this case the business, is worth.

Potential lenders and investors may use the Debt to Equity ratio, which compares the relationship between what is owed (Liabilities) with what is owned (Equity), to learn to what extent the assets are funded with debt rather than equity. If the ratio is high compared to the industry, the company may be labeled as not being able to repay its debts. Although recommended Debt to Equity ratios vary among industries, bankers usually consider this ratio acceptable when it is between 1:1 and 3:1. Where the Current and Quick Ratios measure the company’s ability to survive a short-term financial crisis, a Debt to Equity ratio measures the company’s ability to survive over the long-term.

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<table>
<tr><th>Debt Ratios</th><th>Year 1</th><th>Year 2</th><th>Year 3</th></tr>
<tr><td>My Company's
❏ Debt to Asset Ratio</td><td></td><td></td><td></td></tr>
<tr><td>❏ Debt to Equity Ratio</td><td></td><td></td><td></td></tr>
<tr><td>Industry
❏ Debt to Asset Ratio</td><td></td><td rowspan="2" colspan="2">Debt to Asset Ratio: Total Liabilities* / Total Assets

Debt to Equity Ratio: Total Liabilities* / Total Equity</td></tr>
<tr><td>❏ Debt to Equity Ratio</td><td></td></tr>
</table>

* If your business experiences large variances in assets, liabilities, and equity during the year, calculate these ratios using averages for the period being evaluated.

The more a company's debt exceeds its net worth, the less likely it is to obtain financing. As these ratios increase, the company's ability to obtain financing decreases. Additionally, as more debt is acquired, the owner's position is weakened and those that own the debt (banks, large suppliers) can establish control of the company. Since a high Debt to Asset Ratio may signal to potential funders your inability to meet debt payments, it may be important for you to improve this ratio. In general, the only ways to do so are to increase the value of your assets or pay off debt. A CPA or business consultant can help you evaluate whether inventory or other assets could be assessed at a higher value. Paying off debt will also improve the Debt to Equity Ratio. Another way to improve the Debt to Equity Ratio is to increase equity through retained earnings by increasing profits or additional owner contributions.

Equity

Since your business may be the biggest investment you will ever make, the Return on Equity (ROE) ratio is an important ratio to calculate. By comparing Net Income to Equity, this ratio reveals the rate of return a company has earned on its equity investment. If Return on Equity is 30 percent, for example, then thirty cents of Net Income is created for each dollar that has been invested. The higher the number, the greater the return the company is earning for its owners.

Bankers often refer to Return on Equity as ROI or Return on Investment. Thinking of it this way, your business's Return on Equity should be at least as much as you could have earned by placing money in conservative investments such as CDs or bonds. What could you have earned on the stock market? In a bank account? This information will help you develop Return on Equity goals that will be sure to help you build future wealth in your business.

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Return on Equity	Year 1	Year 2	Year 3
My Company's Return on Equity			
Industry Return on Equity		**Return on Equity Equation:**	Net Income / Total Equity*

* If your business experienced a major change in equity during the year, calculate ROE using an average of the equity over the period being evaluated.

The reason that Return on Equity is such a helpful ratio is that it compares the relationship between three very important financial strategies—profitability, asset management, and financial leverage. Increasing profitability, improving asset efficiency, and proper financial leveraging will all have a positive effect on your Return on Equity.

Some time ago, Dell® computer decided to improve shareholder return by revamping its asset management policies. Better management of the computer components inventory became the focus of their efforts. Inventory and Accounts Receivable are Dell's two most significant assets. By controlling these two accounts, Dell would show increased sales for each dollar of total assets used and increase the basic Return on Equity of the business. Dell increased Inventory Turnover, which means that more cash was available to generate additional sales instead of being invested in assets. Dell's results show how improved asset management can increase Return on Equity because better asset management eventually shows up in the form of increased profit margins.

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