

Keeping Your Bottom Line Strong

By Terry H. Hill

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Henry Ford once said, “Money is like an arm or leg—use it or lose it.” There is a lot of truth in Mr. Ford's statement. One of the biggest challenges that entrepreneurs face when building a business is getting, keeping and managing money.

In fact, of all the aspects of creating, establishing and growing a small business, financial management is the most problematic for small business owners. When it comes to launching and growing a business, sound financial management practices are also the most critical predictor of success.

Without a positive cash flow or a steady source of working capital to pay the rent, utilities, employees, repay debt, or expand your infrastructure, your company won't be in business for long—much less positioned for growth. In fact, poor financial management is usually a fast track to insolvency.

While managing finances may not be one of your strengths, it is critical that you keep your eye on the bottom line. Even if you have hired experts to account for and manage your money, you still need to understand how to analyze your company's performance and assess your business's financial health.

Maintaining good financial records is critical to the success of your business. Accounting and finance are fundamental tools for setting goals, measuring results, and making decisions that depend on sound record-keeping. According to a report by the Small Business Administration, an appropriate record-keeping system can make or break a new business. And, if you're in business already, an appropriate record-keeping system can increase your chances of staying in business.

Good record-keeping provides the foundation for financial reports that are required by banks and government agencies. While these financial reports provide you with a means to better monitor your company's performance, your basic record-keeping system should be easy to use, reliable, and accurate.

There are three financial reports that give you an accurate read on the health of your business, tells you - at a glance – exactly how your business is performing, tells you how well you are managing cash flow, and tells you whether or not you are operating at a profit or at a loss. These reports depict your company's net worth.

The three financial reports are:

- **Cash flow statement:** Cash flow statements report a company's inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and to purchase assets. While an income statement can tell you whether or not your company made a profit, a cash flow statement can tell you whether or not your company generated cash. A cash flow statement shows changes over time, rather than absolute dollar amounts at a point in time. The cash flow statement uses information from a company's balance sheet and income statement. The bottom line of the cash flow statement shows the net increase or decrease in cash for a specific period.
- **Balance sheet:** A balance sheet provides detailed information about a company's assets, liabilities and shareholders' equity. Assets are "things" that a company owns that have value. Liabilities are amounts of money that a company owes to others. Shareholders' equity, sometimes called capital or net worth, is the money that would be left if a company sold all of its assets and paid off all of its liabilities. This leftover money belongs to the shareholders, or the owners of the company. A balance sheet gives you a snapshot of your company's assets, liabilities, and shareholders' equity at the end of the reporting period. It does not show the flows into and out of the accounts during the period.
- **Income statement:** Also known as a profit and loss statement, an income statement is a report that shows how much revenue a company earned over a specific time period (monthly, quarterly, semi-annually, and annually). An income statement also shows the costs and expenses associated with earning that

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revenue. The literal “bottom line” of the income statement shows your company’s net earnings or losses and tells you how much your company earned or lost over the period.

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It is a good idea to examine your business operating ratios and compare them with similar ratios within your industry on a regular basis. The Almanac of Business and Industrial Financial Ratios, published annually by Prentice-Hall, is a good source of financial ratio data that is representative of most businesses in the U.S.

Financial ratios are analytical tools that enable you, your investors, creditors, and shareholders to quickly appraise the financial health of your company, pinpoint strengths and weaknesses, identify trends, and create forecasts. A ratio represents simple arithmetic—the relationship of one number to another. In the world of financial analysis, ratios make it easy to compare performance from year to year, or against other companies or the industry as a whole.

Many different types of financial ratios can be derived from balance sheets and income statements. Examples of balance sheet ratios include current, quick, cash and debt-to-worth ratios. Income statement ratios include gross and net margin ratios. Business efficiency ratios include sale-to-assets ratios, return on assets, return on investment, inventory turnover, inventory turn days, accounts receivable turnover, average collection period, accounts payable turnover and average payment period.

Not all types of financial ratios are as significant, or as relevant, to all businesses. The following financial ratios are some of the most important financial ratios for all types of businesses. Using these financial ratios helps you to answer a few critical questions about your business.

Is your business solvent?

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The Current Ratio is a test for solvency. It provides a clue to the magnitude of the financial margin of safety for the business. The standard guideline for this ratio is 2:1 or higher.

Is your business liquid?

$$\text{Quick Ratio} = \frac{\text{Cash \& accts receivable}}{\text{Current liabilities}}$$

The Quick Ratio is also known as the Acid Test Ratio. It’s used to determine the company’s general liquidity (its ability to pay its current debts). A general standard for this ratio is 1:1 or higher.

Has your business borrowed wisely?

$$\frac{\text{Total debt}}{\text{Net worth}}$$

This operating ratio reveals the extent to which the business has borrowed money. Too much debt may indicate insufficient capital and could weaken the business’s competitive position.

How is your business performing?

$$\frac{\text{Working capital}}{\text{Sales}}$$

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This ratio shows the relationship of working capital to business transactions. Compare this ratio with averages in your industry and related businesses to determine business performance.

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Are your products selling?

Cost of sales
Inventory

This ratio shows the number of times the inventory turns over. A comparison with industry and related business averages can be revealing. Slow inventory, relative to similar businesses within the industry, could indicate problems that will show up in future profitability.

How is your management doing?

Net profit
Net worth

This ratio shows the return on invested capital. Compare it with industry and related business averages. Also compare this ratio with the rate of return you could expect to receive in the equity or financial markets. The risk of running a small business is not worth mediocre returns on investment capital.

Is your business earning a profit?

Net profit
Sales

This ratio measures the profit margin of the business. Compare it with industry and related business averages to see how well your business is doing.

Are your profits adequate?

Cost of sales
Sales

If this margin appears thin compared to the industry average, it could mean future trouble. This indicates how much money is available to pay expenses. Even a small decline in sales for a company with a weak ratio may have serious consequences.

Gains and losses in assets and liabilities that appear on the balance sheet are also reflected in the revenues and expenses that you see on the income statement. Cash flows provide more information about cash assets listed on a balance sheet and are related, but not equivalent, to net income shown on the income statement. No one financial statement tells the complete story. But combined, the cash flow statement, income statement, and balance sheet provide very powerful information for you and your investors to assess the financial health of your business.

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