

## Analysing Balance Sheets

From a financial perspective, the world revolves around the balance sheet and the cash flow forecast. When we forecast our business growth, we must address the issues of what additional assets we will need, and how we plan to pay for those assets. This is where banks come in. Banks finance assets. If we know what our asset growth will be, we can estimate what our financial needs will be. If we can estimate our financial needs, we can involve the bank and finance those needs appropriately.

### Balance Sheet for Sample Company

	Current Year		Previous Year	
<b>Assets</b>				
Cash	\$ 2,200	1.5%	\$ 2,000	1.9%
Accounts Receivable	\$ 70,600	47.6%	\$ 40,200	38.2%
Inventory	\$ 63,000	42.5%	\$ 43,000	40.9%
<b>Current Assets</b>	<b>\$ 135,800</b>	<b>91.6%</b>	<b>\$ 85,200</b>	<b>81.0%</b>
<b>Capital Assets</b>				
Equipment	\$ 25,000	16.9%	\$ 27,500	26.1%
Less Accumulated Amortization	\$ (12,500)	-8.4%	\$ (7,500)	-7.1%
<b>Total Capital Assets</b>	<b>\$ 12,500</b>	<b>8.4%</b>	<b>\$ 20,000</b>	<b>19.0%</b>
<b>Total Assets</b>	<b>\$ 148,300</b>	<b>100.0%</b>	<b>\$ 105,200</b>	<b>100.0%</b>
<b>Liabilities</b>				
Operating Line	\$ 56,150	37.9%	\$ 20,000	19.0%
Accounts Payable	\$ 18,500	12.5%	\$ 7,400	7.0%
Current Portion Term Debt	\$ 2,000	1.3%	\$ 2,000	1.9%
<b>Total Current Liabilities</b>	<b>\$ 76,650</b>	<b>51.7%</b>	<b>\$ 29,400</b>	<b>27.9%</b>
Term Debt	\$ 28,000	18.9%	\$ 30,000	28.5%
Less Current Portion	\$ (2,000)	-1.3%	\$ (2,000)	-1.9%
<b>Total Non Current Liabilities</b>	<b>\$ 26,000</b>	<b>17.5%</b>	<b>\$ 28,000</b>	<b>26.6%</b>
<b>Total Liabilities</b>	<b>\$ 102,650</b>	<b>69.2%</b>	<b>\$ 57,400</b>	<b>54.6%</b>
<b>Equity</b>				
Capital	\$ 45,200	30.5%	\$ 40,000	38.0%
Retained Earnings	\$ 450	0.3%	\$ 7,800	7.4%
<b>Total Equity</b>	<b>\$ 45,650</b>	<b>30.8%</b>	<b>\$ 47,800</b>	<b>45.4%</b>
<b>Total Liabilities &amp; Capital</b>	<b>\$ 148,300</b>	<b>100.0%</b>	<b>\$ 105,200</b>	<b>100.0%</b>

## Balance Sheet Ratios

Three common ratios taken from the balance sheet alone are the working capital ratio, the quick ratio and the debt to equity ratio. Here is how we can calculate these ratios for Sample Company:

The **Working Capital Ratio** measures the ability of a company to repay debt due in the next year. For every dollar in current liabilities, there are this number of dollars in current assets.

The **Quick Ratio** measures the ability of a business to repay debt due in the next year with cash, liquid investments, and accounts receivable. Inventory is subtracted because it may sell for less than paid for if sold as inventory or in distress.

The **Debt to Equity Ratio** compares the investment by the owners to the amount borrowed by banks and suppliers.

Ratio	Formula	Numbers	Answer
Working Capital	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$\frac{135,800}{76,650}$	1.77
Quick Ratio	$\frac{(\text{Current Assets} - \text{Inventory})}{\text{Current Liabilities}}$	$\frac{135,800 - 63,000}{76,650}$	0.95
Debt to Equity	$\frac{\text{Total Liabilities}}{\text{Owners Equity}}$	$\frac{102,650}{46,650}$	2.25

## Financing current assets

As our business grows, we often need to finance increasing amounts of inventory, accounts receivable or both. These are financed in three ways. We can retain earnings from previous year's profits and use this increase in equity to pay for the increased levels of current assets. Secondly we can get some help in financing our inventory through our suppliers in the form of accounts payable. Finally, we need to get financing from the bank. Usually, it is appropriate to get an increase in our line of credit to finance working capital. Sometimes we can refinance our capital assets in the form of a term loan in order to inject additional cash into the business. Financing working capital is one of the most challenging aspects of any growing business.

		Current Year		Previous Year	
Working Capital	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	\$ 1.77	:1	\$ 2.90	:1
Quick Ratio	$\frac{(\text{Current Assets} - \text{Inventory})}{\text{Current Liabilities}}$	\$ 0.95	:1	\$ 1.44	:1
Debt Equity	$\frac{\text{Total Liabilities}}{\text{Total Equity}}$	\$ 2.25	:1	\$ 1.20	:1

Notice that in this growing company, the working capital situation is declining rapidly. This is an early sign of a cash flow crisis. You should also notice the debt to equity ratio.

### Things to consider when financing your current assets

- *If accounts receivable is your key issue, and you have profit margins that can absorb the cost, consider factoring.*
- *Send your invoices out on time.*
- *Watch your bad debt and your problem customers.*
- *Inventory control is critical, especially in industries where the true value of the inventory decreases rapidly.*
- *Monitor different types of inventory and make decisions based on inventory turnover.*
- *The most important advice is to have a plan and review it with your banker.*

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