Financial checks and balances

How solid is your business? It starts with the balance sheet

By Norm Gaither

So, you own your own business and things are going pretty well. The economy is trending upward and sales are starting to normalize, even gaining some momentum after a long and painful economic recovery. You are even considering expanding to a new location, increasing inventory or adding new bays. But what if you don't have the cash to expand? Can you get a loan?

No problem, you think to yourself. So you visit your local banker. After all, you make a profit every month, so he is sure to loan you that extra $200,000 that you need, isn't he?

Maybe the banker will loan you the money you need. Maybe he won't. Just making a profit every month does not guarantee that he will write you a check!

Most small business owners need to know that in addition to your profit and loss statement, the banker will want to look at your current balance sheet. This is one of the most overlooked financial documents by business owners, and yet it's maybe the most important one to consider in examining the financial health of your business.

In my Dealer Strategic Planning 20 Group business, we work with nearly 120 independent tire and service shops. Annually at our meetings, we prepare a balance sheet analysis for every one of our members, and it's an awakening for some to realize the changes they must make to keep their businesses financially strong.

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Balance sheet 101

Let's take a close look at this document. The balance sheet is one of the major financial statements used by business owners, accountants, bankers and other financial people to determine how well a business is performing.

The balance sheet is referred to as a "snapshot" of the financial health of the company at a given time. It quickly shows what the business owns as well as what it owes.

Often, business owners think that if they own 100% of the capital stock in the business, then all of the assets in the company belong to them.

Wrong. All of the assets of the business belong to the business, not the stockholders. All of the liabilities (debts) also belong to the company. What is left over, referred to as "stockholders' equity," belongs to the owner or the stockholders of the business.

Let's look at a balance sheet (Exhibit A). As you can see, all of the assets are listed by category: current, fixed and sometimes other. "Other" typically might be an asset called "goodwill." For example, if you purchase another business and pay more than the asset price, the difference is called goodwill.

Here are the definitions for each sub-category.

Current assets

- Cash: exact amount of cash you have on hand or in the bank account.

Exhibit A

ASSETS		LIABILITIES	
CURRENT:		*CURRENT:*	
Cash	$22,000	Accounts payable	$172,257
Accounts receivable	$285,000	Payroll taxes	$8,400
Inventory	$250,000	Income taxes	$18,311
Prepaid	$3,000	Notes payable, bank	$50,000
Total current assets	**$560,000**	**Total current liabilities**	**$248,968**
FIXED:		Notes payable, long-term	$125,000
Trucks	$177,436		
Leasehold improvements	$187,214	*STOCKHOLDERS' EQUITY:*	
Equipment	$93,274	Common stock	$50,000
Furniture/fixtures	$52,195	Retained earnings, current	$54,933
Accumulated depreciation	($137,406)	Retained earnings, prior	$453,812
Total fixed	**$372,713**	**Total equity**	**$558,745**
Total all assets	**$932,713**	**Total liabilities and equity**	**$932,713**

- Accounts receivable: what your customers owe you.
- Inventory: tires, parts, materials, etc.
- Prepaid: This includes any expense that you pay in advance such as worker's compensation.

Fixed assets
- Trucks: value of vehicles owned by the business.
- Leasehold improvements: this might be adding an office, new roof or any permanent capital improvement to the building.
- Equipment: lifts, shop and office equipment, etc.
- Furniture and fixtures: showroom, office, other fixtures.
- Accumulated depreciation: all the depreciation for the assets on the balance sheet.

Current liabilities
- Accounts payable: what you owe vendors, manufacturers.
- Payroll taxes: what you owe, annualized.
- Income taxes, state and federal: what you owe, annualized.
- Notes payable, bank (current): what you will owe this year.

Long-term liabilities
- Notes payable, bank (long-term): total debt to the bank for more than one year.

Stockholders' equity
- Common stock: amount of money the owner put into the business initially.
- Retained earnings, current: net income this year.
- Retained earnings, prior: accumulated net income since starting the business.

Finally, below the liabilities is the equity. This is the net worth of the business. The balance sheet shows the reader the financial strength or weakness of your company. If a banker is going to loan you money, most of the time it will be based on the performance of the balance sheet, not the income statement.

> A good ratio for a retail store is to achieve seven turns of your inventory if you get same-day delivery by suppliers.

Of course, no one will loan you money on a company that loses money unless you are willing to sign "personal guarantees," which means you must put up all of your personal assets.

Most people do not want to take out a personal guarantee, so it's important to have a good income statement and a strong balance sheet.

Understanding balance sheet ratios

Let's look at some key ratios that a banker will consider after he reviews your income statement.

1. Current ratio. You arrive at this ratio by taking current assets divided by current liabilities. This is a key ratio used by all banks to determine that your current assets are greater than your current liabilities.

A good ratio is 2:1, which means you should have $2 of current assets for every $1 of current liabilities. Higher, of course, is better!

Current assets divided by liabilities = Current ratio
Goal = 2:1 (or higher)

2. Debt to equity: This number is derived by taking total short and long term liabilities (not counting debt for land or buildings) divided by the total equity.

Your banker wants to make sure that you have as much in equity as you do in liabilities.

A good ratio is 1:1 or less. If it's higher, then it means you have more liabilities than you have invested in the company. Most banks want you to have as much (or more) in equity as you do in liabilities.

Total liabilities divided by total equity = Debt to equity
Goal = 1:1 (or lower)

3. Return on assets: This tells the bank how much profit you earn in relation to all of the things you purchase. Take your current net profit (before tax) divided by total assets (not counting land and building) to find this ratio. Many tire dealers like to buy toys, big cars, lots of equipment and, of course, inventory. This will let the banker know if you are able to spend the loan money wisely in order to get a proper return on the assets you purchase. A good ratio to strive for is 10% or higher.

Net Profit divided by Total Assets
(less land and building) = Return on Assets
Goal: 10% or higher

4. Inventory turns. This ratio is determined by taking cost of tire sales (annualized) divided by ending inventory (tires only). If you look at your current Income Statement of cost of tire sales and multiply the current month by 12, then this is what we mean by annualized. If you are looking at three months, then the year-to-date cost of tire sales times four and so on. This ratio will tell the lender how good you are at managing your inventory.

Most of us feel we never have enough inventory, so we spend every dollar to buy tires so we never miss a sale. A good ratio for a retail store is to achieve seven turns of your inventory if you get same day delivery by suppliers. If you stock your own inventory and only get periodic deliveries, a four turns is a good ratio.

Cost of sales (tires) divided by ending inventory (tires) = Inventory Turns
Goal = Four turns or more

5. Return on equity. Net profit (before tax) divided by total equity equals return on equity. This ratio is for the stockholders of the company. If you sold your company tomorrow, you would want to invest the money that you received for the sale of the business and expect a return.

This ratio is the same logic. You own the business, so you deserve a decent return every year. Won't this one day be your retirement?

A good ratio to achieve every year is 20% or higher.

Net Profit divided by Total Equity = Return on Equity
Goal: 20% or higher

Take this to the bank

Once again, you need a healthy balance sheet and also must achieve a reasonable net income on your P&L to get a bank loan. Our 20 Group dealers aim for 10% net income, and many are going well beyond our 10% goal, reaching 15% and beyond.

The average net income for a tire dealer is about 2% to 3%, so our 20 Group dealers use our benchmarks and guidance to at least double this amount and, as you can see, quadruple the amount in some cases.

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At least once a year, your accountant should help you prepare a balance sheet for your review.

Even if you aren't going to visit a bank for a loan, this simple statement will tell you if you are on the right track for financial security. ■

Norm Gaither is president of Dealer Strategic Planning Inc. (DSP), which has formed six 20 Groups made up of non-competing independent tire store owners in the U.S. and Canada. Its goal is to help them improve bottom line profits through idea sharing, financial benchmarking and best practices. DSP and Modern Tire Dealer formed a strategic alliance in 2010 to better serve the tire industry by sharing resources. For more information, see www.dsp-20group.com.