Article 72 February 15, 2009

Staying Balanced in a Rocky Economy

By Sandra Taylor Sawyer, Director, New Mexico Small Business Development Center at Clovis Community College

One of the documents commanding lots of a business owner's attention in these anxious days of recession is the balance sheet, which provides a snapshot of a business's financial health on any given day. Regular review and analysis of the business's balance sheet and other financial data allows an owner to avoid being blindsided and offers him or her an opportunity to change course before a business is in danger of failure.

Anatomy of a balance sheet

Every balance sheet has three major parts: assets, liabilities, and owner's equity. The sum of liabilities plus the owner's equity must always balance with the assets — thus the origin of the term "balance sheet."

Assets break down into two categories: current assets and fixed assets. Current assets are those that will convert to cash in a year or less; they include cash, accounts receivable, supplies and inventory. Fixed assets consist of the business's property, including buildings, equipment and fixtures. These assets have a life expectancy of longer than one year.

The second balance-sheet category, total liabilities, is defined as debt the business owes. Liabilities are broken down the same way total assets are: current liabilities are those to be paid off in a year or less; long-term liabilities are debts that will take more than a year to pay. Current liabilities include accounts, taxes and notes payable. Business loans and mortgages on property are classified as long-term liabilities.

The difference between total assets and total liabilities is called owner's equity or net worth — a figure that illustrates how much of the enterprise the owner actually owns. Net worth can be increased by cash infusions made by the owner and the business's own profits (net income); it can be decreased by cash withdrawals and business expenses (net loss).

How to read the sheet

Two measurements can be taken from a review of the balance sheet: debt and liquidity. Debt indicates how much of other people's money the business is using to operate. Liquidity represents the business's ability to meet its financial obligations.

The most dependable indication of liquidity is known as current ratio, and it's calculated by dividing current assets by current liabilities. A current ratio of 2 indicates that a company could lose 50 percent of its current assets and still be able to meet its current liabilities. Most analysts or lenders would consider this a good margin of safety.

The percent of owner's equity is calculated by dividing the owner's equity by total liabilities and multiplying that number by 100. Most lenders like to see at least 30 percent owner's equity unless the business owner can offer further assurance of his or her ability to repay a loan.

Business owners who consult the company balance sheet at regular intervals can move ahead with confidence based on an awareness of their company's obligations and resources.

Finance New Mexico is an initiative of the New Mexico Small Business Investment Corporation (NMSBIC) and its partners to assist individuals and businesses in obtaining skills and funding resources for their business or idea. To learn more about resources available to New Mexicans, go to www.FinanceNewMexico.org.