Keep Balance to Keep Your Business

The balance sheet is your restaurant's scale of health

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Last month I showed you the importance of your cash flow statement. This might have led you to ask, "If that's the most important financial statement, then why do we even have the others?"

To answer that, let's take a look at the balance sheet, what it does and why it's important, too.

Essentially, the balance sheet is an indicator of how your business has done from its inception and gives you an idea of how the business will do in the future. For instance, if your liabilities are twice what your assets are, you might conclude that business has not been very good and that it may be headed for bankruptcy. If cash is low and fixed assets are high, then you could conclude that the business has used its cash to purchase assets which will in turn make the business more money in the long run. The equity section shows how much has been invested in the business and how the past earnings have been since net income rolls into retained earnings from year to year.

It is very important to keep your balance sheet current so you can examine financial ratios to gauge how your business will perform in the future. Often, small businesses want to max out their expenses for tax purposes, but the end result is their equity in the business looks bad. If a business needs a loan, the bank will look at the balance sheet and run some basic financial ratios to see if the business is healthy and a good credit risk. I recommend that business owners also look at these ratios periodically to see how they are doing. There should be no reason to wait until you need funding to start looking at your balance sheet. I recommend three ratios.

Current ratio = Current assets/current liabilities

This tells you if you can cover your liabilities if you had to close your doors tomorrow.

Inventory turnover = Cost of goods sold/average inventory

This tells you if you are effectively managing your inventory, or if you have too much money sitting on your shelves.

Profit Margin = net income/net sales

This tells you how much of every dollar you get to keep of your sales.

Remember the ratios are only as good as the numbers on your balance sheet and that your balance sheet should be reconciled monthly to make sure that you are looking at the right information.

Finally, the balance sheet is also a great tool for comparing year-to-year or month-to-month business growth. The numbers can be compared directly to see if liabilities are decreasing as expected or to see if cash has increased. You can also run the same ratios for both time periods and compare those results. The most important thing is that you look at it regularly.

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