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Small Business

The Balance Sheet — Barometer of Business

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Even though to many investors the profit and loss statement is of utmost importance, management can tell a lot about the condition of the business by even a cursory look at the balance sheet. Of course, the "insider" sees the balance sheet more frequently, and the changes tell part of the story. Viewed just once and then at statement time, it may not be nearly as informative. Therefore, this article is written from the management point of view.

The Western World is trained to read from left to right and the left-hand side of the balance sheet is the domain of the assets. Therefore, the assets will be considered first.

Cash

The first item on most companies' balance sheet is cash, probably the most active account, since just about every transaction runs through cash at one time or another. If the cash account is "fat" it may give some management people a comfortable feeling. But that may be very deceiving. If cash has some equally "fat" companion over in the short-term borrowing section, the business may be better off with lean cash and less borrowing. Admittedly, banks do not make the planning of cash flow too easy, and in times of tight money, a business may be forced to carry large sums of borrowed capital which, at least at times, may be idle in the cash account. None of the lenders like short-term credit to be on a daily basis — least of all the banks, since the paperwork that they have to process is of mammoth proportions even without borrow-today and pay-back-tomorrow transactions. Computers have come to the rescue to a degree, and some banks have established such systems as "overdraft protection" or "ready reserve" arrangements, which in effect are a daily fluctuating loaning procedure. Every check written in excess of the bank balance constitutes a prearranged loan and every deposit made in the checking account constitutes a repayment in part or in full. The rates of interest are high, but since the money borrowed may be owed for only a short period of time, this arrangement is often cheaper than 90-day renewable notes.

An alternative — also a fairly new aid to the business community — is being offered by Savings & Loan Associations with daily interest-paying accounts. All receipts are deposited in the S & L, and transfers to the checking account of any bank in town are made by the S & L usually the same day and upon telephone notice. The interest earned by the account on deposit with the S & L can offset some of the cost of borrowing at the bank. The only problem here is that the bank might become "difficult" when it sees that it is losing the compensating balances in the checking account. To counteract this loss of available money in the checking accounts, some banks have started to pay daily interest on the balance in checking accounts. It is a highly competitive business, and for once management has some bargaining power.

Accounts Receivable

Some businesses are almost entirely on the cash basis as far as their sales are concerned — and they should consider themselves very lucky. Accounts receivable are a valuable asset, but they become ever so much more valuable when they are turned into cash quickly. Inflation robs the business that must wait for payment for prolonged periods of time. Economists view a 5½% annual inflation rate normal these days, and dark and gloomy predictions place the expected 1974 rate closer to twice that much. Therefore, a six-month delay in receipt of payment can conceivably cause a 2-6% loss in purchasing power — in addition to the cost of borrowed money if the seller is cash-poor.

Of course, there are many ways of turning receivables into cash immediately — factoring, minimum waiting for collection procedures, but again it costs money to have somebody else collect the money, and careful study is required to determine the method of handling accounts receivable which will yield the highest return or cause the least expense.

Prepaid Expenses

Convenience or necessity? That is the question for this category, and insurance premiums are a good example. They must be paid at the beginning of the policy period (or at least within the 30-day grace period). For the convenience of the customer and to ease the pain of paying several thousand dollars at one time, many insurance agencies offer level premium payments. In most cases, the full premium is still prepaid for a period of from six to twelve months at the policy anniversary, and that means that part of the premium is now prepaid 18 to 24 months!

Escrowed taxes! At best, the escrow agent will pay bank-rate interest. This should be compared with the value of the money in the coffers of the business.

Property and Equipment

Here the question becomes: Rent, lease or buy? Or buy, sell and lease back. Many businesses do not have a choice about

their plant. They are so specialized that they are forced to build their own facilities to their own specifications. But, especially with an eye towards inflationary loss of purchasing power, it might be worthwhile to sell the facility upon completion and lease it back. In many cases this may mean the difference between inadequate facilities and room for expansion.

In the area of machinery and equipment the question becomes even more worthy of careful study, since such considerations as obsolescence, possible expansion into related lines of business and the market for used equipment come into play. Naturally, the leasing companies are in business to make a profit, but a thorough study of cash flow requirements and the cost of interest on borrowed money may show some surprising results.

Aside from the rent-lease-or-buy question, the "fixed assets" of a business deserve the closest of scrutiny. Too much equipment, especially in the early years of a business, can put it into a cash crunch that could be fatal. Not enough equipment can mean additional and unnecessary labor costs or missed business opportunities.

In the office equipment area, the good "buys" in used equipment should not be overlooked. Sometimes they are truly amazing.

When it comes to automobiles and trucks, the leasing versus buying proposition has as many staunch supporters as opponents. The dictates of the business are the only valid criteria. These are extremely heavy usage and rapid turn-over, repair service, availability of loan equipment during repair down-time trade-in values of owned equipment, length of lease term, insurance costs, etc. The add-on interest rates in this type of financing and the lease costs are probably very close.

Other Assets

Marketable securities. For the business that has cash reserves earmarked for future expansion, temporary investments in Treasury Bills, Certificates of Deposit or other short-term investments are preferable to having the cash in the checking account. When the demands on these reserves are further removed in time, the choice of the investment vehicle becomes more involved and probably centers around such matters as liquidity, income yield and inflation hedges. The stock market's unpredictability and nose-dive trends of late are enough to give management nightmares, real estate may not be capable of ready conversion to cash when needed, and bonds are subject to inflationary losses. Astute managers to the fore, please!

Required deposits, organization expenses and the like are, in most instances, removed from managerial influence and of very minor importance.

Cash surrender values of life insurance policies. Here is a ready source of working capital and a potential time-bomb at the same time. The interest rates in these contracts are most attractive. But it may well be that the proceeds are needed immediately in the event of the untimely passing of one of the officer-stockholders, such as in a funded buy-out agreement. On the other hand, if the money is to be used to tie the business over until a replacement for a key person can be found, the need for all of the life insurance proceeds may not be immediate, and the business may have a chance to generate the cash by which the insurance pay-out is short due to the loan.

The above is not represented to be a complete list of assets but merely highlights the items found on most balance sheets of small business entities.

Liabilities

The other side of the ledger naturally has the opposite set of rules. Heavy liabilities, especially short-term debts, make management uneasy. Still, the doctrine prevails that the business is operating on somebody else's money, and if these funds are put to good use in the business, the inflationary depreciation of purchasing power can work in favor of the borrower.

On the other hand, discounts take a direct route into profits, and discounting can brighten up an otherwise mediocre profit and loss statement. Therefore, managing accounts payable is really planning for cash flow.

Management must insist on proper accruals of such items as taxes, interest, excess rentals, payroll and other expenses, to be able to make intelligent decisions.

Short-term versus long-term borrowing. Management should make a very realistic appraisal of the working capital requirements of the business to decide whether to go with continuous or repetitive short-term loans or whether it would be more advantageous to seek long-term financing, with or without personal guaranties. In part due to the insistence of lenders, long-term financing is largely limited to real property. But other property, such as "Blue Chip" stocks, insurance policies and bonds, often is acceptable as collateral.

A corporation could float a bond issue, maybe even with a conversion feature to make it more attractive to investors. A partnership or sole proprietorship may have to pledge personal assets of its partners or owner to obtain favorable long-term loans.

The important fact is that a long-term loan will be repaid with at least partially inflated dollars in the future, while the influx of cash enables the business to take advantage of present business opportunities. The value of money is determined by the number of times it turns over in the business cycle.

Equity

The safest source of money is, of course, equity capital. While it is a good investment to the new shareholder or partner when the businessis successful, strong capitalization enables the business to pass more of its profits through to retained earnings and thus back to the stockholders, partners or investors.

In a closely-held corporation, the acquisition of new shareholders may create problems, since the original stockholders are generally very experienced in their fields and used to making decisions without asking anyone else. A second class of stock, without voting rights, can be the answer. It gives the financier the right to share in the profits but not the right to interfere with the day-to-day business decisions. If necessary to attract investors, the second class of stock can be preferred stock with definite and well-defined dividend policies, and again this can be non-voting stock.

A partnership can acquire limited partners with all management duties remaining with the general partners. A sole proprietor can change the business to a limited partnership to obtain equity capital.

It is obvious that management has the obligation to review the balance sheet barometer often and thoroughly, and that it must insist that the facts and figures be accurate. No decision is worth more than the information on which it is based. The balance sheet will be a pretty good indicator of "clear sailing" or "storm brewing on the horizon".