

The Balance Sheet, Demystified

**Unlock its power within
your small business.**

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You Can Understand Your Company's

Balance Sheet

You may or may not find this hard to believe, but most small business owners I meet are puzzled by the concept of *The Balance Sheet*. So if you are perplexed by the Balance Sheet, you are in good company. Because most small business owners need to know how much they're making within their business, they quickly learn to understand the Income Statement, which is also commonly referred to as the Profit & Loss (P&L). The P&L is a fairly easy to read report and after asking a few questions, most business owners feel pretty comfortable reading the P&L and have a general idea how their business is doing when it comes to income. (If you've never been introduced to the Profit & Loss report, please let me know and I'd be happy to introduce you and ensure that you can understand it as well.)

However, most small business owners are never formally trained in reading financial statements and therefore often overlook their importance. They fully invest themselves in running their businesses - putting in long hours, extra effort, and as much enthusiasm as they can muster. Sometimes this is enough to keep things going, but it leaves the business owner feeling as though they are in the dark when it comes to understanding their business financially.

It can be a very discouraging experience. After working with more than two hundred business owners, it is fair to say that over 75% of them admitted to me, after a little coaxing, that they actually had no idea what the Balance Sheet was really all about. Or that they had some familiarity, but they didn't really grasp what was so great about this report or how it could actually help them run their company.

You no longer need to feel discouraged. Today, I am going to let you in on a few of the secrets of the Balance Sheet. I'm going to remove the mystery and show you how to unlock the power of using the Balance Sheet within your small business.

Where to Start

What *is* the Balance Sheet?

**The Balance Sheet highlights the financial condition of a company.
It offers a snapshot of a company's health.**

It might help to think of your company's Balance Sheet as the running scorecard for your business. It shows the financial condition of the business as of the day you create the report.

The formula for the Balance Sheet is:

$$\mathbf{Assets = Liabilities + Equity}$$

The top half of the Balance Sheet lists the assets. The bottom half lists the liabilities and equity (equity is also called capital).

To help us better understand the Balance Sheet; let's look at it this way:

$$\mathbf{Assets = Liabilities + Equity}$$

😊 😞 😊 or 😞

Assets are “happy” things that your company owns.

Liabilities are “sad” debts to others.

Equity is the difference between the two.

The difference between the two is either a “happy” or “sad” remaining balance.

Let's take a look at a company's Balance Sheet and see if the above makes sense.

Understanding the Balance Sheet

The first step to understanding your company's Balance Sheet is to understand the anatomy of the report. If you have a current and up-to-date accounting system, print out a Balance Sheet. (Alternatively, if you have a manual system, refer to your handwritten Balance Sheet).

If you do not have a current and up-to-date accounting system, have no fear. I am providing a sample Balance Sheet for you, and later in the workbook, I quickly and easily walk you through the steps of creating a few sections your company's Balance Sheet so you can still participate in the exercises.

Note: Even if you are familiar with reading a Balance Sheet, take this opportunity to review the Balance Sheet you have printed out from your accounting system. Take note of any figures that may look inaccurate. You may be spotting **red flags** indicating that something is awry in your current system. It's always a good idea to look over your Balance Sheet at least once a month to ensure your system is accurate and up-to-date.

Step 1. Look at either your company's Balance Sheet or the sample sheet provided. See if you can find the section listing the **assets**. To help you find it, remember that assets are always listed first and make up the top half of the Balance Sheet.

Then look for the **liabilities** and **equity**. These always come in the bottom half of the Balance Sheet.

Step 2. Look at either your company's Balance Sheet or the sample sheet and notice how there is a division between the top half and bottom half and there is a total listed for the **assets** section. Then notice that there is also a total listed below the **liabilities** and **equity** section. These two totals are equal to one another. Hence the Balance Sheet is *balancing*! The two sections match and are evenly balanced.

Now you have a basic understanding of your company's Balance Sheet. I hope it's now a little less of a mystery for you.

However, you may be thinking, "Okay, that's great. I learned something (or got a refresher course on something I already knew). But what do these numbers MEAN? And how does this help me run my business?"

Now comes the fun part. Let's **unlock the power of the Balance Sheet!**

Note: If you don't have an up-to-date Balance Sheet for your business, follow these steps to create one for the exercise portion of this workbook.

YOUR BUSINESS'S MINI-BALANCE SHEET

Make a list of the following things your business **OWNS** and total the amounts:

Cash in the bank	\$ _____
Petty cash	\$ _____
Prepaid Expenses (if applicable)	\$ _____
Inventory value (if applicable)	\$ _____
Accounts Receivable (money owed to you)	\$ _____
<u>CURRENT ASSETS TOTAL</u>	\$ _____

Make a list of the following things your business **OWES** and total the amounts:

Accounts Payable (money owed to vendors)	\$ _____
Credit Card balances (include all accts on this line)	\$ _____
Line of Credit and Short-Term Loans	\$ _____
Total of any other amounts your business owes	\$ _____
<u>CURRENT LIABILITIES TOTAL</u>	\$ _____

*Note: The **bold and underlined** figures will be referenced during the exercise. Don't worry about making this mini-Balance Sheet perfect. It's only for demonstration purposes.*

What It Means

How Do We Use Your Balance Sheet To Better Understand Your Business?

Because accounting is the scorecard system of your business, we can use the financial reports to uncover useful information about the financial health of the business. There are a number of important reports created within an accounting system, including the Balance Sheet, Profit & Loss, Cash Flow Statement, and the Accounts Payable (A/P) and Accounts Receivable (A/R) reports, just to name a few.

The Balance Sheet tells us three critical things about your business.

1. *Who owns the business?*
2. *How is the business running?*
3. *How liquid is the business?*

Let's take a look at each piece of knowledge separately and briefly. Then we can focus on the powerful methods I want to share with you today.

WHO OWNS THE BUSINESS?

When you have debt, the lenders own the business.

When you have stock, the stockholders own the business.

When you have retained earnings^{*}, the business owns the business.

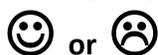
^{*}Definition: Retained earnings are the earnings or profit that a company makes over time.

HOW IS THE BUSINESS RUNNING?

Working Capital is a method used to identify how well the business is running.

The formula for Working Capital looks like this:

Working Capital = Current Assets – Current Liabilities



HOW LIQUID IS THE BUSINESS?

Liquidity is one of the best indicators of a company's financial health. How would things turn out if the company liquidated? If the company converted its assets into cash and paid off all debts, what would be left in cash?



Applying What We've Learned to Your Business

So now we have your company's Balance Sheet (or Mini-Balance Sheet created for this exercise). We have a better understanding of what the Balance Sheet can tell us about your business. How do we apply this and make a difference in your business?

We can apply **ratios** that tell us how the business is doing in different areas. *Ratios?* Sounds frightening, right? Well let me remove the fear factor.

There are quite a few ratios in accounting, but today I'm going to focus on two that work with the Balance Sheet. I'm also going to show you how to apply the Working Capital formula to your company.

Current Ratio

Quick Ratio

Working Capital Formula

THE RATIOS and FORMULA

What	How to Calculate	What It Means
Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	<p>Measures solvency: Tells us the number of dollars in Current Assets for every \$1 in Current Liabilities.</p> <p>For example: a Current Ratio of 1.95 means that for every \$1 of Current Liabilities, the business has \$1.95 in Current Assets with which to pay the liabilities.</p>
Quick Ratio	$\frac{\text{Cash} + \text{Accounts Receivable}}{\text{Current Liabilities}}$	<p>Measures liquidity: Tells us the number of dollars in Cash and Accounts Receivable for every \$1 in Current Liabilities.</p> <p>For example: a Quick Ratio of 1.79 means that for every \$1 of Current Liabilities, the business has \$1.79 in Cash and Accounts Receivable with which to pay the liabilities.</p> <p><i>Note:</i> For businesses with only Cash and Accounts Receivable as Current Assets; Current Ratio and Quick Ratio will be the same.</p>
Working Capital Formula	$\text{Current Assets} - \text{Current Liabilities} = \text{Working Capital}$	<p>Measures both the company's efficiency and its short-term financial health.</p> <p>For example: if the company has more Current Assets than Current Liabilities, the company has sufficient Working Capital.</p>

Let's try it! Grab your company's Balance Sheet or your Mini-Balance Sheet that you created using this workbook.

Fill in the blanks with your company's figures:

Current Assets \$ _____
 Current Liabilities \$ _____
 Cash (total) \$ _____
 Accounts Receivable \$ _____
 Cash + Accounts Receivable \$ _____

Now let's try the ratios and formula with your company's figures:

Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$\begin{array}{r} \text{Current Assets } \underline{\hspace{2cm}} \\ \div \\ \text{Current Liabilities } \underline{\hspace{2cm}} \\ = \\ \underline{\hspace{2cm}} \\ \text{CURRENT RATIO} \end{array}$
Quick Ratio	$\frac{\text{Cash + Accounts Receivable}}{\text{Current Liabilities}}$	$\begin{array}{r} \text{Cash + Accounts Receivable} \\ \underline{\hspace{2cm}} \\ \div \\ \text{Current Liabilities } \underline{\hspace{2cm}} \\ = \\ \underline{\hspace{2cm}} \\ \text{QUICK RATIO} \end{array}$
Working Capital Formula	$\text{Current Assets} - \text{Current Liabilities} = \text{Working Capital}$	$\begin{array}{r} \text{Current Assets } \underline{\hspace{2cm}} \\ - \\ \text{Current Liabilities } \underline{\hspace{2cm}} \\ = \\ \$ \underline{\hspace{2cm}} \\ \text{WORKING CAPITAL} \end{array}$

You have just identified your company's Current Ratio, Quick Ratio, and amount of Working Capital! (If you immediately want to talk to someone about what you've just uncovered in your business, please [contact me](#) and I will help you.)

Why It Matters

Now, you may be wondering why this exercise really matters. You understand the Balance Sheet more than you did before. And you now know three things you didn't know about your business before. But you're really not sure what it means and why it matters.

Perhaps the Balance Sheet, ratios, and formula seem simple. Or perhaps it seems like a whole lot of work to figure out. The reason why it matters is because this information about your business is **POWERFUL**.

The **Balance Sheet** allows the reader to quickly learn a lot about the financial fundamentals of your business. We can quickly see how much debt the company has, how much is owed by customers, how much cash is in the bank, and what kind of income the company has generated over time. These are all important factors that need to be identified by anyone who wants to improve the business, make decisions within the business, and understand the health of the business.

Case Study

When I first met Dan, he was keeping his company's books by hand. He had tracked and captured each and every expense purchase, client sale, vendor payment, and all other detailed transactions that were taking place within his business's financial activities.

What Dan was lacking was a system that generated financial reports on a regular basis. His system lacked the ability to provide him with the wisdom and knowledge he needed to make better business decisions. As soon as we automated his accounting system, we were able to regularly and easily produce financial reports, including a **Balance Sheet**, and identify areas to be targeted for improvement.

Once we did this we could see that Dan's clients were not always paying quickly and this meant Dan had to constantly use cash to pay his vendors while waiting for his clients to pay him. Once we knew this, Dan started sending his clients

monthly reminder statements and payments started coming in much more regularly than they had been.

This gave Dan the opportunity to use his cash for business-building activities, like advertising and marketing services. The investment he made into a better bookkeeping system has greatly paid off by giving him the knowledge he needed to make better business decisions that are leading to the growth of his company.

The **ratios** are also a powerful way to evaluate the business and compare the business to other companies within its industry.

I can tell you that, in general, a good indicator of financial health within a business is a **Current Ratio** of 2. For most business industries, you want to see a Current Ratio indicating that the business has in Current Assets at least \$2 for every \$1 of Current Liabilities. This means if the business had to pay off all of their Current Liabilities today, they would still have half of their Current Assets leftover after making the payments.

If I look at the **Quick Ratio**, I know that I want the ratio to be 1 or higher. If the ratio is 1 or higher, it indicates that the company has enough cash and liquid assets to cover its short-term debt obligations. If the company is carrying too much debt relative to its cash and current assets that can easily be liquidated into cash, it can indicate a high risk for future bankruptcy.

Case Study

When I first met Tina, she was having a hard time paying her vendor bills on time. I helped her update her accounting system so we could use it to identify what might be causing her to experience this challenge.

Once I was able to calculate the **Current Ratio** and **Quick Ratio** for Tina's business, I identified that Tina was keeping too much inventory on hand at any given time. She had been paying her vendors for goods she had already purchased from them, but had not yet sold to her customers. By keeping less product in stock, she kept cash in her business longer and had an easier time paying her vendor bills.

Working Capital is similar to the Quick Ratio. Positive Working Capital indicates that the company is able to pay off its short-term liabilities. It is important to pay attention to Working Capital because if it dips too low, the business risks running out of cash. Even a very profitable business can run into trouble if it loses its ability to meet short-term payment obligations. However, having too large a balance in Working Capital can be an issue as well, especially if most of the Working Capital is tied up in Accounts Receivable.

Case Study

When I first met Patrick, he was having a hard time running his business. He knew he was making a profit, so he was very confused by his constant struggle to pay bills, pay himself, and have cash in the bank.

It quickly became apparent that issues with his company's **Working Capital** were contributing to Patrick's problem.

His company's Accounts Receivable balance was very large because he allowed his clients to pay on terms and most were taking between 30 and 60 days to pay. This means his clients were getting his services without paying very soon thereafter; meaning Patrick had earned the revenues but didn't have them in cash.

In addition, his company's Accounts Payable balance was very small. Patrick always paid his vendors on time and often as soon as he received their bill. He wanted to show his vendors that he cared greatly for their services and did so by paying right away. Sometimes he even paid for services in advance. This means his vendors were being paid very quickly or upfront while he was waiting to be paid by his own clients.

By understanding and applying interpretations of ideal **Working Capital** conditions, I have assisted Patrick in running his business so he no longer struggles with the challenges he experienced before utilizing my service.

The Story Behind the Numbers

When a business owner or trusted outside advisor creates and maintains an accurate and up-to-date accounting system, including a Balance Sheet, the business can react as necessary to improve the business based on the knowledge and wisdom we can gain from the ratios and formulas you've learned about today.

As a Professional Bookkeeper, I regularly provide my clients with a report called **The Story Behind the Numbers**. This report provides a plain English interpretation of the client's business. It utilizes the Balance Sheet and Profit & Loss, calculates Ratios and compares the business to other businesses in the same industry, and, most importantly, this report provides action steps the business owner can take to change and improve their business.

The Story Behind the Numbers Report is a powerful component of the service I provide for my bookkeeping clients. If you are interested to learn more about this report and would like to see it in action, there is a sample of this report available on my website at heartbasedbookkeeping.com/sample.pdf.

Next Steps

If you found the activities in this workbook beneficial and would like to leverage the power of an easy, automated, and powerful bookkeeping system within your business, [contact me!](#)

There are additional resources, including a [free assessment](#) to help you evaluate your current bookkeeping system, available on my website at:

www.heartbasedbookkeeping.com

One of my greatest joys and accomplishments in business is helping other small business owners discover the knowledge, wisdom, and peace of mind that is within reach through their accounting system. Helping entrepreneurs turn their bookkeeping problems into profits and peace of mind is the goal of Heart Based Bookkeeping.

Thank you for sharing part of your busy day with me and for taking the time to utilize my free workbook. I hope the workbook has provided you with insights into your business and a better understanding of some of the ways that Heart Based Bookkeeping can assist you and your business.

My very best to you, your family, and your business,



Jessica Reagan Salzman



If this workbook has helped you and your business, please don't keep it a secret. Share the experience you've received by sending your friends and colleagues to my website for my free e-zine and workbook.



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Helping entrepreneurs turn their bookkeeping problems into profits.

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