Balance Sheet – Knowing the Basics of Liabilities

Executive Summary: The balance sheet says a great deal about a company. If you're a business owner you better know how to read your own, as well as that of your clients and subcontractors. This week we discuss the *Liabilities* section.

Just the basics. My recent article introduced the balance sheet. The balance sheet is one of the three most important and common financial reports (the income statement and the cash flow statement being the other two). Know the basics of the balance sheet.

Here's the balance sheet in one simple mathematical equation:

Owner's equity = Assets – Liabilities

And, the variables defined:

- <u>Assets</u> – things of value like cash and equipment.
- <u>Liabilities</u> – things you owe money on like loans or supplier invoices.
- <u>Owner's equity</u> – this is also known as member equity, equity, and net worth.

The second section in any balance sheet will be the *Liabilities* section. This is the section which represents money that is due and owing to someone other than you (the *Assets* section was money coming in to your company, or, in other words, money owed to you).

The balance sheet should be of interest to you, if for no other reason than the users of this document make financial decisions on your behalf based upon it. I'm talking about your banker, your surety agent, your clients, and maybe even your suppliers/subcontractors.

Liabilities. The scenario on the *Liabilities* side of the balance sheet is very similar to the *Assets* section, in that *Current Liabilities* are those due within the next 12 months (recall that *Current Assets* were monies coming in to you in the next 12 months). All the other liabilities outside of, and below, this section are due later than the immediate 12 months.

To me, the three most important lines in this section of the balance sheet are *Accounts Payable* (how much money is owed to subcontractors and suppliers), *Long Term Debt* (debt due after the next 12 months), and *Current Portion of Long Term Debt* (the portion of long term debt due in the immediate 12 months).

My Story. In my experience with the balance sheet, and specifically the *Liabilities* section, here's what to know:

- <u>Accounts Payable</u> – if this number gets too high, it's real simple – it means you're not paying your subcontractors, vendors, and/or suppliers in a timely fashion. Your good looks and smile may carry your slow pay behavior for a while, but eventually

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those parties not getting paid have to eat too, and you will start to see a change in behavior by those parties:

- Higher quotes on products and services
- No quotes on products and services
- Change in payment terms – they're now holding you to pay-when-paid clauses or to a true Net 30 or perhaps you will be put on COD (cash on demand).
- You'll get invited to a meeting with the chief executive of the company you're not paying and you'll have to listen to him/her tell you how they're a pipe supplier and not a bank. For me, his volume was an 18 (out of 10) on the dial, and there was an explicative there between "I'm not your…" and "…bank!". Absent half the letters from Vanna White, you can probably solve this puzzle.
- Your client (the one paying you) will start to joint check you (a joint check has two parties on it, your company and that supplier). You cannot put it in your bank account – you simply endorse the back of it and hand it to the second party.

- Working Capital – in the contracting business, this is the most important calculation you can make on yourself or on your subcontractor

  Working Capital = Current Assets – Current Liabilities

  This is a measure of a contractor's most valuable asset: cash.
  If this number is small or negative, it means times are tough or are about to be.

  Before you read the next bulleted section, read the equation above again. And know that *Working Capital* usually has a direct link to survival of your business and the value of your bonding capacity. The working capital number needs to be big, and correct.

- Current Portion of Long Term Debt – this is one that will have your CPA sitting at a tension in his/her chair when you ask about it. Because you're not supposed to be this sophisticated and you're not supposed to know to be inquiring about it. I caught my CPA on it once and my controller on it more than once. Here's a simple example to show you why it's so important (interest excluded for simplicity):

You buy an excavator today:	$200,000
You finance it for 5 years:	$40,000 due in 1st year
	$160,000 due in years 2 through 5

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It follows that,

*Current Portion of Long Term Debt**:	$40,000
Not the *Current Portion of Long Term Debt*:	$160,000

*The current portion being that due in the next 12 months.

Did you figure it out? Do you see the reason it's important? It has to do with *Working Capital*. Remember above that

Working Capital = Current Assets – **Current Liabilities**

Your financial professional is making a $160,000 error if (s)he doesn't properly account for this in the balance sheet. The error that can be made is that the entire $200,000 is kept in the *Current Portion of Long Term Debt* and your *Working Capital* is understated by $160,000.

But here's where it has a direct impact on your company: your bonding limit. Your bonding capacity is like a credit card – it has a limit. Your bonding program may be in the range of 15 times your *Working Capital*. The mistake above, if made, to your bonding limit is

15 * $160,000 = $2,400,000

This is $2,400,000 of work you cannot chase because of an error in your financials.

Time to educate your controller, or to find a new CPA. If you're going to pay an accounting firm $20,000 a year, they shouldn't be making $2,400,000 errors.

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