

Making Sense of Your Balance Sheet

by Judith Miller



ILLUSTRATIONS BY DAN DRABEK

Many construction companies suffer from what I call the arrogance of profitability. When times are good, the company owner buys new tools and trucks, and the latest in office equipment, and may also invest in speculative projects. When the economy slows down, however, these companies are left with no resources. Many have no choice but to declare bankruptcy.

Wiser builders are more conservative, maintaining liquid cash reserves equal to six months of overhead expenses.

They continually monitor their finances to protect their company, their family, and their employees.

The difference between builders who survive a downturn and those who don't lies partly in the way each uses the two main types of financial statements: the income statement and the balance sheet. The *income statement* (often known as the profit/loss statement, or P&L) summarizes a stream of income from different sources over time, typically the current month or year. It also separates

A few simple equations can help you gauge your company's financial health

BALANCE SHEET

(as of 3/31/95)

	Company A	Company B
ASSETS:		
Current Assets:		
Cash/Bank of New Hope	\$15,000	(\$2,500)
Market Rate Account/Bank of New Hope	\$2,500	\$0
Accounts Receivable	\$22,500	\$12,000
Inventory	\$4,000	\$4,000
Prepaid Assets:		
Workers Compensation Deposit	\$1,000	\$1,000
Current Liability Deposit	\$500	\$500
General Liability Deposit	\$0	\$0
Total Current Assets:	\$45,500	\$15,000
Fixed Assets:		
Vehicles	\$32,000	\$32,000
Accumulated Depreciation/Vehicles	(\$12,000)	(\$12,000)
Tools and Equipment	\$12,500	\$12,500
Accumulated Depreciation/Tools & Equipment	(\$4,000)	(\$4,000)
Total Fixed Assets:	\$28,500	\$28,500
Other Assets:		
Mortgage Receivable	\$40,000	\$70,500
Total Assets:	\$114,000	\$114,000
LIABILITIES:		
Current Liabilities:		
Accounts Payable	\$12,000	\$24,500
Payroll Taxes Payable	\$3,800	\$3,800
Workers Compensation Payable	\$1,200	\$1,200
Vacation Benefit Payable	\$600	\$600
Medical Insurance Payable	\$400	\$400
Total Current Liabilities:	\$18,000	\$30,500
Long-Term Liabilities:		
Notes Payable/Fixed Assets		
Truck loan	\$18,000	\$18,000
Bobcat loan	\$6,000	\$6,000
Notes Payable/Other		
Note to Dad	\$15,000	\$30,000
Total Long-Term Liabilities:	\$39,000	\$54,000
Total Liabilities:	\$57,000	\$84,500
Owner's Equity:		
Paid-In Capital	\$5,000	\$5,000
Retained Earnings	\$50,000	\$22,500
Owner's Drawing	(\$10,000)	(\$10,000)
Profit/Loss YTD	\$12,000	\$12,000
Total Equity:	\$57,000	\$29,500
Total Liabilities Plus Owner's Equity	\$114,000	\$114,000

KEY TERMS

ASSETS (Listed in order of liquidity)

Current Assets

- **Cash** — all checking accounts and other short-term investment accounts
- **Accounts Receivable** — all money owed to the company from projects under construction or completed (including retainage)
- **Prepaid Assets** — any amounts paid in advance, such as workers compensation and general liability insurance deposits
- **Inventory** — unfinished projects and work in progress not yet billed, as well as physical inventory not yet committed to a project

Fixed Assets

- **Fixed Assets** — all assets whose expected life is longer than the current year, such as vehicles, equipment, and buildings (fixed assets are usually depreciated on your tax return)
- **Other Assets** — assets that are neither current nor fixed, such as long-term notes receivable or mortgages receivable

LIABILITIES (debts due for payment soonest are listed first)

Current Liabilities

- **Accounts Payable** — all trade payables as well as overhead expenses payable
- **Payroll Taxes Payable** — employer and employee portions of all taxes
- **Other Payroll Liabilities** — workers compensation, medical and other insurance benefits, union dues and benefits, and the payroll portion of general liability insurance

Long-Term Liabilities

- **All notes, mortgages, and loans** whose principal amount is payable at any time after the current 12-month period

Owner's Equity (for a sole proprietor)

- **Paid-In Capital** — the initial investment made to start the company
- **Retained Earnings** — the calculated value of all profit and loss held in the company, from inception to the beginning of the current tax year
- **Owner's Drawing Account** — the amount of money the owner has taken out of the business during the current fiscal year
- **Profit/Loss YTD** — total from the Net Profit line of the income statement for the current period

A balance sheet presents a complete picture of a company's long-term financial health. Similar balance sheets, however, can tell two very different stories. While most of the amounts in the examples above are identical, Company A is in very good shape, while Company B's weak assets and heavy liabilities spell disaster.

direct costs — such as materials, labor, and subs — from overhead costs. The result is either a profit or a loss for the reporting period (see “Small Builder’s Guide to Accounting,” 10/94).

It is dangerous, however, to rely solely on the income statement, because it presents only a short-term picture. The income statement emphasizes the profitability of current projects, but does not take into account a company’s long-term indebtedness and other indicators of financial health.

The Accounting Equation

To truly understand the financial strength of your company, you must understand the *balance sheet* as well as the income statement. The two reports act together to give a complete picture of the company at any time.

Putting together a balance sheet is more than an exercise in bookkeeping. The amounts listed on the balance sheet tell a story about your company, but you need to know how to read it. The first step is to understand the relationship between *assets*, *liabilities*, and *owner’s equity*.

The arithmetic of the balance sheet follows the basic accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Assets include everything a company owns, and appear first on the balance sheet; liabilities are listed next, and include everything a company owes. Owner’s equity (sometimes called “net worth”) appears last on the balance sheet, and includes the owner’s original investment, as well as any accumulated profit from previous years. Owner’s equity also includes up-to-date data from the income statement. This amount is entered on the balance sheet after the label “Profit/Loss YTD.”

Ratio Analysis

Balance sheet totals show the effects of company profitability since the day the company started. Unfortunately, the balance sheet totals don’t tell you much on their own. The two companies shown in the sample balance sheet on the preceding page have identical income statements (right). Yet Company A is in much better financial shape than Company B.

How can you tell? Bankers and creditors use a shorthand system called *ratio analysis* to interpret balance sheet information, and to quickly determine if a company is a good credit risk.

Leverage ratios measure the risk of debt. While debt is not, in itself, detrimental to a company’s financial health, risk increases when debt and interest expense increase. One way lenders decide whether or not to loan money is with the *equity-to-assets ratio* (expressed as a percentage), which measures how much of the risk is shared by the company owners:

$$\frac{\text{Total Equity}}{\text{Total Assets}} = \frac{\$57,000}{\$114,000} = 50\%$$

This example shows that Company A’s owner has a 50% interest in the company, well above the acceptable minimum of 33%. Bankers will be reluctant to lend money to

Company B, however, because its 25% ratio means the bank is taking 75% of the risk.

Similarly, the *debt-to-equity ratio* shows how much of the company assets are financed by owners versus outside lenders:

$$\frac{\text{Total Liabilities}}{\text{Total Equity}} = \frac{\$57,000}{\$57,000} = 100\%$$

Company A’s 100% ratio indicates a strong capital position capable of expansion without a great degree of risk to the owner or lender. At the other end of the scale, Company B’s 286% ratio indicates that creditors own a

INCOME STATEMENT

For the period 1/1-3/31/95

Income:

Remodeling Income	\$86,000
Tenant Improvement Income	\$14,000
Miscellaneous Income	\$2,000
Workers Comp Dividend	\$800

Total Income: **\$102,800**

Direct Expenses:

Materials	\$11,200
Subcontract	\$17,600
Labor	\$35,000
Payroll Taxes	\$3,800
Workers Comp	\$4,800
Benefits	\$600
Other Direct Expenses	\$1,200

Total Direct Expenses: **\$74,200**

Gross Profit: **\$28,600**

Gross Profit Margin: **27.8%**

Overhead Expenses:

Accounting	\$800
Bad Debts	\$0
Bank Charges	\$12
Dues/Subscriptions	\$120
Education/Seminars	\$200
Insurance/General	\$2,800
Interest/Finance Charges	\$200
Office Labor	\$6,000
Office Supplies	\$2,000
Rent	\$1,500
Repairs/Maintenance	\$860
Small Tools	\$300
Telephone/Pagers/Mobile Phone	\$608
Utilities	\$1,200

Total Overhead: **\$16,600**

Net Profit: **\$12,000**

Net Profit Margin: **11.7%**

An income statement summarizes the profitability of a company’s operations over a given period. Net profit or loss from the income statement is also plugged into the balance sheet to bring owner’s equity up to date.

much larger portion of the assets and therefore have a greater risk in the company than the owner does.

Liquidity ratios (also called “debt and capital ratios”) measure a company’s ability to repay its short-term debts. The most common ratio of this type is called the *current ratio*. It predicts the company’s ability to pay current liabilities (those due within 12 months) using current assets (those that can be converted to cash within 12 months). Using amounts from Figure 2, Company A’s current ratio looks like this:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$45,500}{\$18,000} = 2.5$$

(By convention, some ratios are expressed as a straight quotient while others are expressed as a percentage.)

The rule of thumb is a 2:1 current ratio; in other words, company assets should be at least twice liabilities. Company A is in very good shape, but Company B’s current ratio of .5 indicates serious financial trouble.

The *quick ratio* defines a company’s ability to repay current bills using only cash and accounts receivable — inventory and work in progress are not included. Company A’s quick ratio looks like this:

$$\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}} = \frac{\$45,500 - 4,000}{\$18,000} = 2.3$$

Also called the “acid test,” the minimum quick ratio should fall between .5 and 1. Company A meets this criterion with flying colors; Company B, however, is in trouble again, with a quick ratio of .36.

The *doomsday ratio* is the most stringent of the liquidity ratios. It does not recognize any current assets as liquid except for cash:

$$\frac{\text{Cash}}{\text{Current Liabilities}} = \frac{\$15,000}{\$18,000} = .83$$

If business dried up tomorrow, Company A could pay most of its short-term debts without having to liquidate assets;

for Company B, tomorrow might very well be doomsday. Because cash balances fluctuate, however, the doomsday ratio is more meaningful when measured over time and averaged.

Return ratios measure the percentage return provided by the activities of the business. One common type — the *return on owner’s investment ratio* (also called “return on net worth”) — shows the percentage of profit produced from every dollar of the owner’s investment:

$$\frac{\text{Net Profit Before Taxes}}{\text{Total Equity}} = \frac{\$12,000}{\$57,000} = 21.1\%$$

Because of the great risk associated with contracting, the return should be high — 10% is desirable. Although different people will expect different levels of return, anything less than money market returns is indefensible from a purely economic point of view.

The return ratio can be misleading, however. Company B’s return ratio, for example, is about 41% (\$12,000 ÷ \$29,500). The owner is getting a good return on his money because he has so little money invested. As the other ratios show, creditors own most of Company B, and if a couple of jobs fall through, the high return on investment will not be enough to keep Company B from going out of business.

Righting Wrong Ratios

What can you do if your ratios are headed in the wrong direction? In most cases, unfortunately, there are no quick fixes. An infusion of cash will help, but borrowing money may only add to your problems. It would be better to redouble collection efforts on accounts receivables (to add cash) and to reduce expenses (to increase net profit). Also consider not taking money out of the business unless you can invest it at a high but secure rate of return.

Avoid making a lot of capital purchases without analyzing the effects of the investment. If you’re considering buying a new truck, for example, first run a “what-if” on how the debt will affect your balance sheet. Then compare the purchase price to the cost of repairing and maintaining your old truck. The same kind of analysis is useful for business decisions, such as renting larger office space, buying new equipment, or increasing your line of credit.

Using ratios to monitor your business adds another dimension to financial management. Instead of concentrating solely on gross volume, job costs, overhead, and short-term profits, ratios allow you to foresee and with luck forestall problems, while encouraging positive developments. National firms prepare industry-standard balance sheets and financial ratios to which you can compare your progress. The NAHB (800/368-5242) publishes an annual Profit/Loss Survey by type of builder and for different regions of the country. Robert Morris Associates (One Liberty Place, 1650 Market Street, Suite 2300, Philadelphia, PA 19103; 215/851-0585) also publishes ratios by industry. ■

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