



CONSTRUCTION INDUSTRY UPDATE:

Procedures to help maximize a contractor's
working capital position at year end.

WORKING CAPITAL—REVISITED

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Working capital simply stated is a company's current assets minus its current liabilities. The amount of working capital a company has is the direct result of net earnings retained by the shareholders in the company, less any amounts used to acquire long term assets such as property and equipment. Companies that have a long history of earnings will have a strong working capital balance which will provide the company with business flexibility, the ability to get through a recession, and most importantly for a contractor, provide the basis for their bonding program.

Current assets for a contractor are normally made up of cash, accounts receivable, including retainage, costs and estimated earnings in excess of billings, inventory, and prepaid expenses. A contractor may also include in current assets

marketable securities, due from affiliates and shareholders. Current liabilities for a contractor are made up of an amount due on the line of credit, current portion of long term debt, billings in excess of costs and estimated earnings, and accrued expenses such as payroll and related payroll taxes, insurance, income taxes and year-end bonuses. For S Corporations, a contractor may choose to accrue the shareholder distributions that are expected to be paid out by the contractor subsequent to year end due on the flow through income to the owners. Though GAAP does not require an S Corporation to accrue the distributions that will be paid to its shareholders, we strongly recommend that a contractor, at a minimum, disclose the amount to be paid in the tax footnote to the financial statements. Remember, amounts that are included in the contractor's current assets and liabilities are

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expected to turn over in the company's normal operating cycle the following year.

As of the contractor's year end, referred to as its financial position, the makeup of the contractor's current assets and liabilities will be evaluated by its surety to come up with the contractor's adjusted working position at year end. I spoke with Michael Gilbert, of the DeSanctis Insurance Agency located in Woburn, MA. Mike is a veteran insurance and bonding agent for the construction industry and he noted that, although each surety may evaluate working capital differently, they will in general adjust a contractor's working capital for the following reasons:

- Exclusion of accounts receivables over ninety days;
- Exclusion of prepaid expenses;
- Exclusion of any due from shareholders or affiliates, unless the balance is paid subsequent to year end prior to the opinion date on the contractor's financial statements;
- Inventory, depending on its makeup, may be discounted by the surety by 10 percent to 50 percent;
- Costs and estimated earnings in excess of related billings may be excluded if it is due to a loss contract or if the contractor does not have a legitimate reason for being under-billed as of year end, such as being on a different method of revenue recognition (accrual) for income tax reporting, or if it is due to language in the contract.

Mike also noted that marketable securities, although not commonly seen on a contractor's balance sheet, may be discounted by the surety up to 50 percent based on the risk associated with the portfolio.

The contractor's current liabilities will be evaluated by the surety to ensure that deferred income taxes and accrued expenses such as workmen's compensation and general liability insurances are properly stated as of year end. As previously mentioned, the contractor's balance sheet as of year end is the contractor's financial position as of that one day. It is the basis for the users of the financial statements to determine what the bonding and banking programs will

be for the upcoming year. That said, it is imperative that a contractor maximize its financial position as of year end in order to improve the makeup of its working capital. This process starts three to four months prior to year end as follows:

Current Assets:

- **Cash**—As of year end the contractor should have a minimum of ten to twenty day's cash on hand. This is achieved by following up on cash collections and managing the accounts payable and line of credit balances.
- **Accounts Receivable**—During the last four months of the year, the monthly requisitions should be sent out timely and accurately to avoid delays on being paid. Retainage should be monitored and also followed up on for final billing and collection. Pending change orders for work performed and costs incurred should be followed up on for timely approval and billed. Pending change orders as of year end that are approved subsequent to year end should be documented and a list compiled and picked up as of year end as unbilled accounts receivable.
- **Costs and Estimated Earnings in Excess of Billings**—As previously stated, a balance in this balance sheet account is normally a danger sign to the surety of potential loss contracts. Unless the language in a contract causes the under billing, (contract does not allow a contractor to bill up front for mobilization) the balance in this account should be kept to a minimum. The contractor should be able to show the surety that subsequent to year end, any under billings by contract were billed.
- **Inventory**—A contractor, during the last four months of the year, should be working the inventory balance down by using available materials on ongoing jobs. This will also help improve the contractor's cash flow.
- **Due from Shareholders/Affiliates**—Any balances in these accounts

should be cleared up by year end. If the balances cannot be paid by year end, the contractor should disclose in the related party footnote to the financial statements when the amount(s) were paid subsequent to year end to avoid exclusion by the surety from working capital.

- **Prepaid Expenses**—Since the surety excludes from working capital the balance in prepaid expenses as of year end, the contractor should keep these balances as low as possible. The prepaid expenses on a contractor's balance sheet most of the time are deposits made prior to year end on insurance policies in effect the following year, thus cannot be avoided.
- **Marketable Securities**—A contractor should keep the money as cash and avoid investing in marketable securities at all cost. Unless, that is, the contractor has a mature balance sheet, is extremely well capitalized, and has excess working capital where as the amount taken out of cash to be invested would not compromise the company's bonding program. Also, the company's investments should be conservative.

Current Liabilities:

- **Line of Credit**—As of year end, a contractor should apply excess cash to reduce the line of credit balance to zero or as low as possible. Although this does not affect a contractor's working capital, it does help improve the company's debt-to-equity ratio.

- **Current Portion of Long-Term Debt**—This balance represents the total debt payments currently due on long-term assets, primarily property and equipment, financed through term notes with financial institutions. As a rule of thumb, contractors should never use cash to purchase long-term assets due to the effect it has on its working capital. When property and equipment (exclude land and building) are financed, the term of the note should match the estimated useful life of the asset. The effect on working capital of purchasing long-term assets is the down payment on the acquisition and the current portion due on the note payable.
- **Accounts Payable**—Accounts payables are primarily made up of contract costs and, as with the line of credit, excess cash should be used to pay down the balance at year end. Again, this will have no effect on working capital and will help improve the company's debt to equity ratio. Note: Contractors will only apply cash receipts on current contract receivables against accounts payable due on those specific contracts. Also, it is important for the contractor to keep accounts payable days outstanding in line with industry standards and vendors' expectations.

A contractor, by following the above procedures to maximize its working capital position at year end, will provide the surety the basis for a strong bonding program. ■