

Making Working Capital Work for You

By Frank Balog, CPA

If you are a general contractor working (or planning to work) on federal or state projects, you are required to purchase a construction bond. Additionally, state projects require your company to be prequalified for a capacity over and above the contract price. Luckily for contractors, understanding one key concept can help keep the surety company happy and the prequalification capacity high – working capital.

Working capital, in its simplest form, is merely the amount by which your current assets exceed your current liabilities. Managing this number is not only sound business practice, but can be the key to obtaining bonding and prequalification, as modified versions of it are used by sureties and states to calculate their capacities. Therefore, it is paramount for contractors to understand how to leverage working capital, and also how it is viewed by both sureties and states, so that you can maximize working capital and your company's potential.

The following are some best practices for maintaining and improving working capital:

Use Long-term Debt. The prospect of long-term debt may be frightening at first, but in the midst of times when interest rates are extremely low, the utilization of debt can be very helpful. Long-term debt can help to increase working capital by:

- Providing current cash. This is a direct boost to the working capital number, at the cost of financing the debt, by increasing current assets without increasing current liabilities.
- Paying down or “terminating out” line-of-credit balances or accounts payable. This increases working capital by transferring current liabilities to long-term liabilities. Additionally, lines-of-credit with available capacity are looked on favorably by sureties and states.
- Purchasing equipment or other fixed assets. Using cash or lines-of-credit to purchase equipment hurts working capital by shifting a current asset (cash) to long-term (equipment), without reducing current liabilities. Making use of financing reduces the current impact. Additionally, contractors should analyze whether a piece of equipment will be needed for future projects, and whether it would be more beneficial or practical to lease the equipment.

Sell Excess Equipment. Equipment (and other fixed assets) that have remained idle for a period of time aren't making your company any money by sitting there, so why not sell them? The market for them might not be at its peak right now, but idle equipment can be turned into cash, thereby increasing your working capital, bonding and prequalification capacities.

Invest in the Business. Not only are sureties more comfortable with an owner that exhibits confidence in his or her business, but contributing money increases working capital by providing cash in exchange for equity or a long-term note. In most cases, it will be beneficial to subordinate a long-term note to the surety, as they may treat subordinated loans as equity (as do most banks). Along these same lines, try to keep officer dividends and bonuses to a minimum. While it's OK to reward yourself for your hard work and your company's success, taking all of the profits out of your business will reduce its ability to grow, and also to gain additional bonding and prequalification capacity. Be prepared to explain large dividends (or distributions for flow-through entities) and bonuses to the bonding company.

Accelerate Progress Billings and Collections. If you're running a successful business, you probably know the importance of cash flow. Keeping your billings and collections as current as possible will certainly help to get cash in the door, but it has even more benefit to contractors trying to effectively manage their working capital. First and foremost, surety companies will discount receivables greater than ninety days old when calculating working capital, so it's even more important to follow-up on those items and collect them efficiently, or obtain explanations for the surety. Also, costs in excess of billings and estimated earnings (a current asset representing the amount of revenue recognized by the percentage-of-completion method of accounting less billings on the project) is a number often challenged by sureties if it represents more than 25% of total working capital. While a surety may accept this asset with a valid explanation, the issue can be overcome altogether if billings are expedited. If possible, have a manager hand-deliver invoices or progress billings so that they're available to settle any disputes quickly.

Keep Current Assets Clear of Bank Liens. Sureties will often times discount or disallow assets held as collateral or that have other liens attached when calculating working capital, so try to keep these current assets free and clear of liens.

Do Not Prepay Expenses. Prepaid expenses are considered current assets by United States Generally Accepted Accounting Principles, but surety companies will not include them when they calculate working capital. When possible, avoid prepaying expenses such as insurance, workers compensation and rent and keep the current benefit of your cash. If your insurance or workers compensation policy requires an up-front payment, try to have the policy dates correspond closely to your fiscal year, so that any prepayment made at the beginning of the year is utilized and charged off by year end.

Get Whole-Life Insurance Policies Instead of Term for Officers. If your company has taken out insurance policies on the lives of its officers, it can be beneficial to working capital if the policies are Whole-Life (or Permanent) policies instead of Term. Whole Life policies have a cash surrender value, which sureties will add in as a current asset when they calculate working capital. Term policies have no such feature.

Investigate the Possibility of a Joint Venture. Often times a company may be interested in a project, but just does not have the manpower, bonding or prequalification capacity to land the job. In this case, it may be beneficial to form a joint venture with another company that's in the same boat. By combining your assets (and your working capital), you may be able to get the project and benefit both of your companies. Of course, when investigating the possibility of a joint venture, make sure you're educated about your potential partner.

Become familiar with Your State's Prequalification Calculation and Requirements. Each state has a different way of calculating prequalification capacity, but many of them focus on some form of working capital. Some states will include the cash surrender value of officers' life insurance. Some states will include a factor for the amount of equipment owned or leased. Some states will include available borrowings from lines-of-credit. Whatever your state's calculation method is, become familiar with it and know how to structure your transactions to maximize your capacity.

Most of these points are also sound business strategies for asset management. As we struggle through these difficult economic times, cash flow and asset management are more important than ever. Hopefully these tips can help keep your business running, and make your working capital work for you.

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