# Construction Executive This Week

## Tangible Working Capital and Tangible Equity: What Do These Ratios Mean to Your Business?

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A contractor's financial statements are distributed to a variety of users, including owners, sureties, banks and other lenders, contractor licensing boards, departments of transportation and potential joint venture partners. Each entity may calculate various ratios using certain account balances throughout the balance sheet, income statement and statement of cash flows.

Users review key ratios to assess the contractor's financial health, stability and capacity. Ratios such as working capital, debt to equity, liabilities to equity, cash to revenue, net overbilling or underbilling as a percentage of construction revenue and gross profit percentages are commonly evaluated.

Users also will analyze the information found in the footnote disclosures and supplementary information to take the aforementioned ratios a step further. They may drill down to understand the quality—not just the quantity—of working capital and equity. This additional analysis determines tangible working capital and tangible equity.

**TANGIBLE WORKING CAPITAL**

Traditionally, working capital is calculated by subtracting current liabilities from current assets on the balance sheet. Contractor licensing boards and departments of transportation often set licensing and bid capacity limits using this calculation. However, sureties and lenders often take this ratio a step further to arrive at tangible working capital. This calculation begins with regular working capital and the amount is adjusted by being reduced for various underlying amounts.

The most frequent tangible working capital adjustments include:

- subtraction of accounts receivable aged greater than 90 days, unless subsequently collected in a reasonable time period;
- amounts currently receivable from related parties and employees;
- thirty percent to 50 percent of inventory balances depending on the composition of the inventory and the inventory turnover rate;
- costs and estimated earnings in excess of billings on uncompleted contracts (underbillings), excluding underbillings on unbilled contracts that are in the startup phase;
- retainage not expected to be collected during the current operating cycle;

- prepaid expenses; and
- other miscellaneous current assets.

The sum of these adjustments is subtracted from working capital to arrive at tangible working capital. Depending on the specifics of a particular contractor's financial statements, there can be a dramatic difference between working capital and tangible working capital.

**TANGIBLE EQUITY**

The same lines of adjustment are made to working capital in order to arrive at tangible working capital. Total equity is straightforward and is the net of total assets less total liabilities.

The calculation of tangible equity begins with the equity balance, reduced by the same adjustments previously made to calculate tangible working capital, and is then further adjusted for any long-term related party accounts or notes receivable, goodwill, non-compete agreements, customer lists and other intangibles.

The tangible equity is a barometer for the contractor's true "operational" level of equity on a day-to-day basis.

**BENCHMARKS**

Both tangible working capital and tangible equity can significantly influence a user's takeaways from a contractor's financial statements. These calculations factor into surety credit, debt borrowing bases from financial institutions and operational capacity.

Benchmarks of tangible working capital equal to or exceeding 7.5 percent of annual contract revenue and tangible equity greater than 10 percent of annual revenue will keep a contractor in a favorable position.

Contractors and their CPAs and sureties should discuss and evaluate their tangible working capital, tangible equity and other relevant ratios on a regular basis. These discussions will lead to a clear understanding of their current scorecard, as well as create opportunities to plan for future needs. Proper planning should be considered and implemented prior to the contactor's year-end so that the final results showcase the most favorable position.