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Maintain a Healthy Balance Sheet for Financial Security

By Robert Mercado and Michelle Johnson | Wednesday, November 13, 2019

The health of a contractor's financial statements is imperative to obtain credit from financial institutions and bonding companies, as well as potential awards of future contracts. To secure the future profitability of a company, there are certain areas on the balance sheet of the financial statements that should be examined. At a minimum, those areas should include:

- Prepaid expenses;
- Fixed assets;
- Line of credit; and
- Stockholder(s) loans.

PREPAID EXPENSES

Contractors typically enter into various types of agreements with vendors to pay up-front costs for items that are charged as expenses to the company over time. A common example of such an agreement is worker's compensation insurance (WC).

Contractors normally pay a large down payment of the insurance premium, followed by consecutive equal payments over the remaining months of the policy. Contractors should record these payments as prepaid expenses. The WC insurance expense is then amortized and recorded on the income statement, based on usage and not on the actual cash flow of the payments. This will have a significant impact on the balance sheet and the income statement of the contractor.

To illustrate, assume Company XYZ enters into an annual WC renewal with a total premium of $500,000 and an initial down payment of $100,000 due Oct. 1. The remaining payments are calculated over the next 10 months at $40,000 each. As of Dec. 31, total payments would amount to $180,000.

Also assume the total amount that should be recorded as an expense, based on the activity of the employees covered under the WC, was $75,000 during this period. The amount to be recorded as prepaid expense should, therefore, be $105,000 ($180,000 to $75,000).

If the company is not accurately capturing its prepaid expenses, it puts itself at risk for understating the prepaid expense asset on the balance sheet, which ultimately understates equity by overstating expenses, which in turn understates or reduces profitability.
In certain cases, insurance companies require contractors to finance WC policies. While this benefits the insurance company, it can have a negative impact on the contractor's financial statement. The loan would be recorded on the balance sheet as a current liability. As such, this would have a significant negative effect on the contractor's working capital ratio.

FIXED ASSETS

Many contractors rely heavily on equipment. Purchased equipment is recorded at cost on the balance sheet. The cost of the equipment is then written off (expensed) over time through depreciation expense.

Depreciation differs for financial reporting purposes as compared to tax reporting. For tax reporting purposes, equipment is depreciated using accelerated methods (methods of calculating depreciation) and class lives (how many years the asset will be depreciated). For financial reporting purposes, equipment is depreciated based on the economic useful life of the asset, less a salvage value.

If a contractor uses the incorrect method or life of the equipment, depreciation would be accelerated as an expense, which grossly impacts the financial statement. If depreciation is inadvertently inflated, it will be reflected as a reduction in the contractor's gross profit on projects, directly lowering the overall profit of the company. The contractor's equity, in turn, decreases due to the over-recording of depreciation and reduction of profit, as does the net book value of the equipment on the balance sheet. To properly express the company's financial position in the financial statements, contractors must accurately report the useful lives and salvage value of the equipment purchased.

LINE OF CREDIT

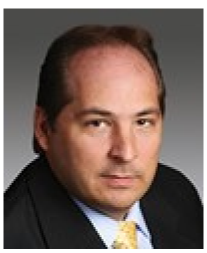
Contractors often secure a line of credit to help with cash flow needs. Lines of credit are typically renewed on an annual basis. Contractors would derive greater benefit by negotiating with financial institutions for a multi-year renewal. If the contractor has a renewal date that is more than a year and a day from the balance sheet date and the financial institution has historically renewed the line of credit, the balance on the line of credit can be reported as a long-term liability. This will result in a more favorable outcome for the contractor as it will increase the company's working capital.

STOCKHOLDER(S) LOANS

In some instances, the financial strength of a contractor may be dependent on a loan from the stockholder (or stockholders). In that event, the nature in which the loan is repaid will affect the financial statements. If the stockholder is not expecting the funds to be repaid within a year, a loan agreement should be prepared to show that funds are not due until after a year and a day from the company's year-end. This allows the loan itself to be shown as a long-term liability, while the cash received is reported as a current asset.

This presents a positive position for working capital. It may also be required that the loan is subordinated to the company's financial institution or bonding company. Should this be requested, the stockholder should consider recording the contribution in the equity section, instead of as a loan, which would be considered a more permanent solution.

Contractors continually look at how the outside world views their financial stability based on their financial statements. With proper planning and a thorough understanding of how particular items are required to be reported and the subsequent impact of each, a company can be confident in having financial statements that reflect its financial health.



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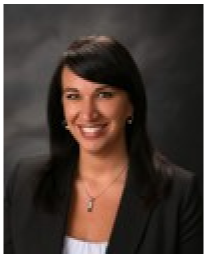

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