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Optimize the Balance Sheet to Find Hidden Equity

By Christopher Sisk and Robert Mercado | Tuesday, July 13, 2021

Financial statements are the contractors' annual chance to tell a story about the financial health of their company. The question is, what story are they telling? Contractors provide financial statements to various internal and external users for a variety of different uses. These users include internal management, financial institutions, surety companies, state licensing boards and customers of the contractor. Management uses financial statements to understand how the company has performed and to make informed decisions about the company's future. External parties use the financial statements to make decisions about credit, work capacity and whether the contractor has the wherewithal to perform on a project.

Whatever the reason, it's imperative that the financial statements tell the correct story; otherwise, decisions can be made that are not right for the contractor or the external users of the financial statements. There are certain accounts on contractors' financial statements that should be scrutinized more fully to ensure the amounts are recorded properly to optimize the balance sheet and, more importantly, maximize the equity of the company. Those accounts relate to inventory, fixed assets and loans from shareholder(s).

INVENTORY

Most contractors will have minimal inventory due to the fact materials are purchased specifically for a project. There are cases where a contractor will purchase inventory because of the lead time associated with a particular item or for items frequently used on a majority of jobs. If a contractor has a significant amount of inventory, it's important to understand why. Inventory is usually discounted by sureties in their tangible working capital calculation and ties up cash flow for the contractor. When cost is charged to a project, revenue and gross profit are recognized based on the percentage of completion. If inventory is not properly recorded as a cost that should be charged to a project, the inventory can be overstated on the contractor's financial statement and project costs can be understated. Contractors should analyze inventory balances on a regular basis to ensure costs that should be charged to a project are not being carried as inventory. If the inventory is project specific, but uninstalled, this can be costed to the job and record revenue in the same amount as the inventory cost.

FIXED ASSETS

Property and equipment used in the contractor's activities are referred to as "fixed assets." Fixed assets are recorded on the contractor's balance sheet as a long-term asset at cost, net of accumulated depreciation and amortization. The cost of these assets is amortized to the income statement over time through depreciation.

There are various methods to record depreciation, such as straight-line and double-declining balance. The straight-line method takes the total cost of the asset (less any salvage or residual value) and divides this cost over the months during which the asset will be depreciated (estimated useful life). Each month the contractor will record the same amount of depreciation expense until the asset is fully depreciated. The double-declining balance method is used to accelerate the depreciation of an asset and will produce greater depreciation at the beginning of the assets life and less depreciation at the end of the assets life. This method is primarily used for tax purposes to obtain a larger write-off earlier in the ownership of the asset. Contractors also frequently use, for income tax purposes, bonus depreciation or IRC §179 deduction, taking up to 100% of the cost of the asset in the first year as an expense.

It's important to note that depreciation for financial statement reporting purposes should be different than depreciation recorded for tax purposes. Unfortunately, for simplification, many contractors use the same financial reporting and tax depreciation methods and asset lives in both cases. This will have a negative effect on the contractor's balance sheet and equity, as it understates the actual value of property and equipment and overstates expenses. Contractors should depreciate assets for financial statement purposes using the straight-line method over the estimated useful life of the asset.

A frequent mistake on a contractor's financial statement is using incorrect estimated useful lives, meaning how long an asset will be useful to the contractor. Many contractors will use the lives prescribed by the tax code and not the useful life of the asset. For example, a contractor purchases a large excavator worth $500,000. The excavator is anticipated to last for 10 years, which would amount to $50,000 per year of depreciation. Under tax rules, exclusive of direct write-off methods, the excavator can be depreciated over a five-year life, which would amount to $100,000 per year. This is a large difference in the value of the asset retained on the balance sheet under fixed assets and a significant reduction in the expense in the short run on the income statement. In addition, using the useful life of the asset better matches the use of the equipment and the cost associated with it. It is also important for a contractor to use consistent estimated useful lives across each asset class.

LOAN FROM STOCKHOLDER(S)

There are times when the stockholder(s) of a construction company will be required to loan the company funds. It's important to understand the placement of this loan on the balance sheet under the liabilities of the company. If the loan is not expected to be paid in a year of the date of the financial statement, or the loan has been subordinated to an outside party, such as a financial institution or a surety, the loan should be shown as a long-term liability as opposed to a short-term liability. The reason this is important is that a short-term liability will have a direct result on the contractor's working capital. Working capital is important to the users of the financial statement, as their views of the contractor's credit and cash flow strength will be based on the amount of working capital. In addition, if the loan is subordinated, many outside parties will consider this to be equity instead of a liability. This is a good way to increase the equity in the company without contributing funds into capital and providing for interest to be paid on the loan from the stockholder(s).

CONCLUSION

Focusing on how items are recorded on a contractor's financial statements is imperative for management to make the right decisions and to optimize how outside users of the financial statements view them. It is considered best practice for a contractor to review their financial statements with external users, especially with sureties and banks/creditors, to ensure there are no incorrect assumptions made by external users. Contractors have one chance per year to use their financial statements to tell a story; make sure you control the narrative.

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