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INTRODUCTION

The purpose of this document is to help contractors better understand the bonding process, the different types of bonds and how to maximize bonding capacity within your companies. The length of time it takes to obtain a surety bond depends on the specifics of your business and how quickly you can provide the Bonding Agent with the information required. Occasionally the Agent will discover information about your business that may negatively impact your ability to obtain a bond, however a good Bonding Agent should be able to identify these issues early on. The process can take anywhere from a few days to a few months.

Getting preapproved for bonding does not typically cost anything. However, once you identify a specific project to bid on, you will need to pay a premium to obtain a bond. The bond premium is a percentage of the total bond value. This cost can range from 1/2% to 15% depending on various factors, including your business’s financial health and the nature of the project. In many cases the cost of the bond is in a tiered structure whereby smaller bonds cost a larger percentage and larger bonds cost a smaller percentage.

There are several parties involved in the issuance of a bond:

1. The Owner who is either legally required to obtain a bond or is doing so at their discretion
2. The Contractor or Subcontractor who is obtaining the bond and guaranteeing to either bid a project, perform a project or make payments as required for services rendered
3. The Surety Company who provides the various types of bonds

Each party’s role will be discussed throughout the balance of this discussion.

THE ROLE AND IMPORTANCE OF BONDING

Contractor bonding is becoming increasingly important. Bonds ensure owners that the contractor can deal with problems that may arise causing challenges to the contractor’s business. Examples of these issues might include things such as labor shortages, material shortages, material delays or cash flow issues. If a contractor goes bankrupt, there will likely be projects in progress that need to be completed by other parties. Bonds are designed to ensure owners their project will be completed.

Owners of construction projects need to work with contractors who are open, transparent and trustworthy as well as people who have enough resources to sustain the project until completion.

There are also different types of bonds. A bid bond, payment bond and performance bond are the most common bonds used in the construction industry. The most important bond is the performance bond which provides maximum financial security and assurance that the construction project is going to end successfully. The performance bond gives the project owner assurance that the contractor will be able to pay all subcontractors who are working for the firm as well as all vendors who supply materials. Owners benefit much from the contractor’s bond because they stand a better chance of completing their projects smoothly since there is an agreement guiding their interaction with the contractor.

Why Bond

Although surety bonds are mandated by law on public works projects, the use of bonds on privately owned construction projects is at the client’s discretion. Alternative forms of financial security, such as letters of credit and self-insurance, do not provide the 100% performance protection and 100% payment protection nor do they assure a competent contractor. With performance bonds, the risks of project completion...
are shifted from the owner to the surety company providing the bond. For that reason, many owners require payment and performance bonds from their contractors to protect their company and shareholders from the enormous cost of a contractor failure.

To bond a project, the owner specifies the bonding requirements in the contract documents. Obtaining bonds and delivering them to the owner is the responsibility of the contractor, who will consult with a surety bond producer. Subcontractors may also be required to obtain bonds to help the prime contractor manage risk, particularly when the subcontractor is a significant part of the job or a specialized contractor that is difficult to replace.

Most surety companies are subsidiaries or divisions of large insurance companies, and both surety bonds and traditional insurance policies are risk transfer mechanisms regulated by state insurance departments. However, traditional insurance is designed to compensate the insured against unforeseen adverse events. The policy premium is actuarially determined based on aggregate premiums earned versus expected losses. Surety companies operate on a different business model. Bonding is designed to prevent loss. The bonding prequalifies the contractor based on financial strength and construction expertise. The bond is underwritten with little expectation of loss.

What is a Bonding Company?

Before we describe how to choose a bonding company that fits your needs, it is important to define them and understand how they work.

Surety bond companies are usually large organizations that provide surety bonds, in addition to other insurance products (this is why some refer to them as “surety bond insurance companies”).

Due to how complicated the surety bond industry is, a bond company will not work with and provide bonds directly to the public. Bonding companies use bond agencies that work directly with people who need bonding.

How to Select a Bond Producer Company

For most, the best way to run a company in an organized fashion is to hire bond professionals they can count on to assist in decision making. A bond producer well versed in contract bonding should be a top priority. If your agent is not knowledgeable enough or does not have the markets to fit your company’s needs, then there is little they can do to help with your bonding needs. An experienced bond producer is a must to ensure you are competitive in your bids and to allow for a bond line size that suits the needs of the contractor.

Obtaining surety credit starts with professional bond producers. Arranging bonds and a line of credit with a surety company requires extensive, detailed work for every bid that a contractor or subcontractor submits. Each surety company has its own unique underwriting standards and practices, and the prequalification process to obtain surety credit can be a difficult experience if not handled by a surety bond specialist. Surety bond producers are licensed business professionals who have specialized knowledge of surety products, the surety market, and the business strategies and underwriting differences among sureties. A bond producer can serve as an objective, external resource for evaluating a construction firm’s capabilities and, where necessary, can suggest improvements to help the construction firm meet a surety company’s underwriting requirements. A bond producer also can introduce the construction firm to other helpful professionals and consultants, such as certified public accountants and attorneys, when appropriate. Finding the right fit in bond producer and surety relationships can be quite beneficial for the growth and development of a construction firm.

In choosing a bond producer, construction firms should consider the following information in their selection process. Please note that the following questions or points are not exhaustive and are intended merely to provide examples of possible questions to ask and factors to consider when assessing whether a particular bond producer might be a good fit for your company’s needs.
Is the producer licensed in your jurisdiction and that of the project?

What is the reputation of the bond producer? Does he or she have a reputation for integrity and respect in the industry?

What percentage of his or her overall business are construction clients?

Do they have an understanding of the construction industry and of the construction process, particularly the management and administration of construction contracts?

Does he or she possess knowledge of construction accounting procedures, especially an ability to analyze financial statements, work-in-progress, and cash flow?

With how many sureties does the producer work?

Is the producer specifically authorized to issue bonds on behalf of sureties?

Has the producer developed solid relationships with other professional service providers, such as attorneys, CPAs and lenders?

How aware and interested is the producer in local, regional and national construction markets?

How active is the producer in local or national construction associations, such as the American Subcontractors Association, Associated Builders & Contractors, or Associated General Contractors of America, and in local or national surety industry associations, such as the National Association of Surety Bond Producers?

Can the producer demonstrate a commitment to maintaining frequent client contact through newsletters, site visits, or visits to client offices?

What other services does the producer provide clients to help them with their business needs?

Additionally, a great resource to find a bond producer in your area is through the NASBP (National Association of Surety Bond Producers) at www.nasbp.org.

HOW BONDS WORK

Sureties can accept the risk of contractor failure based on the results of a thorough, rigorous, and professional process in which sureties prequalify the contractor. This prequalification process is an in depth look at the contractor’s business operations.

Before issuing a bond, the surety company must be fully satisfied that the contractor has, among other criteria:

- Good references and reputation;
- The ability to meet current and future obligations;
- The experience matching the contract requirements;
- The necessary equipment to do the work or the ability to obtain it;
- The financial strength to support the desired work program;
- An excellent credit history; and
- An established bank relationship and line of credit.

The surety company must be satisfied that the contractor runs a well-managed, profitable company, keeps promises, deals fairly and performs obligations in a timely manner. Bonding has played an important role in the construction industry’s success, allowing the industry to sustain its position as one of the largest contributors to the nation’s economic stability and growth.

Construction is a risk-filled enterprise, and even capable and well-established contractors can ultimately fail. Of the 1,021,350 general contractors and operative builders, heavy construction contractors, and special trade contractors operating in 2014,
only 722,281 were still in business in 2016 – a 29% failure rate.¹ Despite the bonding company’s rigorous prequalification process and best judgment about the qualifications of the contractor, sometimes contractor default is unavoidable.

However, when a contractor fails on a bonded project, it is the surety company that remedies the default – not the project owner and not at taxpayers’ expense. In the unfortunate event that a bonded contractor does default, the surety has legal obligations to the project owner and the contractor. First, the client must formally declare the contractor in default. Then the surety company conducts an impartial investigation before settling any claim. This protects the contractor’s ability to pursue legal recourse if the owner improperly declares the contractor in default. When there is a proper default, the surety’s options often are spelled out in the bond. These options may include the right to re-bid the job for completion, bring in a replacement contractor, provide financial and/or technical assistance to the existing contractor, or pay the penal sum of the bond.

MAXIMIZING BONDING CAPACITY

As a contracting business matures and develops, larger projects and higher bond amounts naturally are needed. Yet, there may be an unanticipated hurdle. Bumping against the construction bond limit, or construction bond capacity, can come as a surprise to many contractors. Often, contractors are not aware or informed enough about the existence of this limit in the first place. Or even if they are, they may not know how to increase it. Your construction bond limit is the maximum value of bonds that you can obtain across all projects. There is the single limit, which is the maximum value of a single bond for any project, and there is the aggregate limit (or bond line), which is the maximum total amount or value of bonds you can get. Typically, your bond line is set by your surety when you apply for contract bonds – most often, performance and payment bonds. For smaller projects (up to $350,000) sureties will often only consider an applicant’s personal credit score. Based on the score, a surety will determine the rate at which you can obtain your bond as well as your bond line. Sureties use personal credit score as an indicator of how likely you are to trigger a bond claim but also how likely you are to sort it out. High credit scores are typically taken to mean that the person will be able to handle a claim, if one should arise, and will not default on the project.

But your personal credit score, high as it may be, is simply not enough to guarantee how you will handle projects that are above $350,000 or in the millions. When it comes to bond lines, sureties exercise great scrutiny, so you should be prepared to provide plenty of information if you want your limit to be raised. This means providing information about the Capital, Capacity and Character of your company, the so-called ‘three Cs’ of bonding.

Capital

While a surety looks for evidence that a contractor can complete a job, it’s also preparing for a bad outcome. If the bond is called, the surety intends to recover its losses with claims against the contractor’s assets, and it makes sure beforehand that there are assets at the ready.

Sureties look at capital to get a sense of the contractor’s financial ability to complete projects. They focus on working capital (current assets minus current liabilities), which gives them a sense of the contractor’s ability to meet their current obligations. If you have significant capital that is locked up in long-term assets that are not easily converted to cash, your bonding capacity will be limited.

Profitability is also important. If profitability has significantly declined or is negative and it lasts for more than one year, sureties get nervous. There are many things contractors can do to improve bonding capacity related to the capital component:

- Collect accounts receivable in a timely manner.
- Understand your customer’s payment policies

and manage the process so that cash is collected within 90 days:

- Invoice jobs in a timely manner and be ready to explain underbillings and unusual overbillings;
- Reduce bonuses and overhead when profits are declining;
- Review financing agreements and consider refinancing short term-debt for long-term debt;
- Limit riskier assets such as related party receivables, inventory, or other assets not easily convertible to cash;
- Provide accurate and informative reporting, and avoid large profit fade or gain;
- Pursue capital infusions, if necessary.

**Ownership Structure**

The structure of your business will be required to be detailed with profiles and background summaries of management team leaders. The most common ways to organize a business are:

- sole proprietorship
- partnership
- limited partnership
- limited liability company (LLC)
- corporation (for-profit)
- nonprofit corporation (not-for-profit), and
- cooperative

**Company Financial Statements**

Make sure your financials are strong. Your bank and tax statements will be reviewed to help the surety to determine how well you handle money. What’s your working capital look like? How’s cash flow? Are you staying on top of receivables? Are you profitable? All those questions will be on the surety’s list. Also, surety companies like to see liquid assets or working capital equal to at least 7-10% of the remaining cost to complete backlog for subcontractors and no less than 5% for general contractors.

Bonding companies want to see a debt-to-equity ratio no higher than 2 to 1. In other words, the debt on a contractor’s balance sheet should not represent more than twice the equity.

Timely and periodic financial information is key to increasing bonding capacity. Besides showing organizational commitment, transparency, and good administrative skills, periodic financial information allows contractors the opportunity to demonstrate to the surety how project earnings are positively impacting the balance sheet, working capital, and net worth. The higher the working capital and net worth, the higher the bonding capacity will be. Withholding financial information to avoid reflecting losses is never a good practice, as sureties have other ways of finding out the contract status, including, but not limited to contractor status requests to owners, claim letters, underbillings, and so on. A surety might also simply reduce or decline to renew the surety bonding line if the financials are not received.

**Personal Financial Statements**

Personal Financial Statements are typically required from all indemnitors. The underwriter gets these financial statements annually, and they are used to see if the owner has any additional liquidity available, should it be needed, and also to determine the worth of the supporting indemnity. Generally, you must own in excess of 10% of the company before a surety will require you to provide personal indemnity. In cases of very large, experienced companies, usually with working capital and net worth in excess of $10 million, and more than 10 years in business, the surety may consider waiving personal indemnity entirely. It is a worthy goal for any contractor to strive for the waiver of personal indemnity.

**Work in Progress**

Surety underwriters and accountants determine a contractor’s “current workload” based on the costs they must incur (such as labor and materials) to complete their open contracts. When there are no
remaining costs to incur on a project, it is considered completed. The WIP schedule shows revised “Costs Incurred to Date” and “Estimated Costs to Complete.” Both increased costs incurred and decreased future costs improve available capacity. Future costs may be reduced by progress on the contracts as well as greater labor efficiency, material cost savings, improved scheduling and other factors. A reduction in the contract amount (by change order) has the same effect because it reduces cost not incurred. Report such amendments immediately.

**Bonding Capacity Based on Adjusted Working Capital**

There is no “one-size-fits-all” formula; the calculation is contractor-specific, based on risks determined through review of a contractor’s reputation, experience, and organization. A contractor’s bond limit is largely determined by working capital and net worth as reflected in the fiscal year-end financial statements. In general, surety credit is based on the lesser of 10 to 20 times adjusted working capital or 10 to 20 times net worth. Different surety companies have different appetites for risk, and sureties may adjust various factors in the working capital calculation.

**Line of Credit**

Cash will always be the primary driver. A contractor with a strong net cash position may be able to fund problems without turning to third parties, e.g., the surety or others. The larger a contractor’s cash position at reporting periods, the more favorably a bond company looks upon that contractor’s qualifications. Maximize working capital at reporting periods. This means maximize available liquid assets while minimizing current liabilities. Restructure any debt if possible.

**Personal Guarantees**

Your bonding capacity reflects your financial strength, financial reporting, management team strength and how it is presented to a bonding company. Your bonding agent can suggest creative ways to increase your capacity like personal guarantees, set-aside funds or joint ventures. The bottom line is you will get bonds based on how much liquid assets you maintain in your company. The more you have, the larger your bonding capacity will grow.

**Credit References**

Surety bond companies periodically check a variety of credit reporting sources and question irregularities. Trade payments should be kept current. Pull company and company ownership credit records regularly. Report errors for correction immediately.

**Capacity**

When looking at capacity, sureties consider the contractor’s experience and skill, equipment resources, personnel resources, and availability under line of credit. They do not want to see a contractor working on projects with which they do not have prior experience. They also do not want to see contractors overextending themselves by taking on more projects than they can handle. If contractors show they have a good business plan, understand how to manage their resources, and don’t overextend themselves, it gives sureties comfort and they are more willing to bond projects.

**Description of the Business**

The description of the business usually begins with a short description of the industry. When describing the industry, discuss the present outlook as well as future possibilities. You should also provide information on all the various markets within the industry, including any new services or developments that will benefit your business. When describing your business, the first thing you need to concentrate on is its structure – by structure we mean the type of operation. State this upfront in the description, along with whether the business is new or already established.

In addition to structure, legal form should be reiterated. Detail whether the business is a sole proprietorship, partnership or corporation, who its principals are, and what they will bring to the business. Once you’ve described the business, you need to describe the services you provide. The service
description statement should be complete enough to give the reader a clear idea of your service (and any product) offerings.

**Competitive Differentiators**

Identify what might set you ahead of another construction company with the same core competencies and a similar project history. What makes you, your team and your business uniquely qualified?

These can include areas such as:

- Preconstruction
- Virtual Design and Construction
- Schedule Management, Quality Control
- Prefabrication
- Self-Performance
- Safety

**Budgets, Accounting Systems and Controls**

For many reasons the construction contractor must maintain an appropriate cost accounting system. Its records must adequately reflect job costs, the very heart of the business, and the essential ingredient in preparing accurate financial statements. The contractor, who may be preoccupied with daily operations, cash flow needs, and selling new work is often unable to dedicate the time or may lack the necessary skills to determine accurate cost data for each job completed or job in progress.

A controlled job cost system, often viewed as an accounting luxury in the past, has become a necessity for proper financial statement presentation and control of costs. Without controlled job cost information, accurate reporting on a basis acceptable to a bonding company becomes a burdensome chore.

The contractor who attaches importance to providing a surety with appropriate financial data in a timely fashion reaps the benefit of obtaining performance and bid bonds with much less difficulty than one who postpones the task. For the contractor who believes that a major portion of future work will require bonding, information gathering must be as important a priority as any other business building effort.

Bonding companies want to deal with contractors who are conscious of, and responsive to, financial reporting requirements. This responsiveness may seem an onerous task at the outset but becomes more simplified as the ritual is performed on a regular basis.

Contractors should provide their surety bonding agents a transparent look into the companies so they can see firsthand the processes involved in estimating, project management and accounting. Agents don’t want to see that these areas operate in silos. Instead, they want to make sure that the moving parts of a project work together smoothly. For example, agents can be invited to a company’s weekly or monthly project meeting to see the team in action. It’s also advisable to give surety agents tours of some worksites so they can observe operations and meet the team.

**Character**

Sureties are not willing to provide bonding capacity to those they cannot trust. Therefore, the contractor’s character is a very important consideration when evaluating bonding capacity. Character is something that is earned over time, and it is based on integrity and reputation.

Sureties make a determination of character by the quality of the work, relationships with suppliers and subcontractors, relationships with the bank and other service providers, and the ability and willingness to communicate problems quickly. Sureties do not like surprises, and they want to be informed promptly when problems arise.

They also do not want to see contractor assets being mismanaged on non-business-related activities. Contractors with bonuses that appear excessive, related party loans that are not in the ordinary course of business, or family members’ earnings that do not appear to be in-line with their job responsibilities can all be cause for concern.
Increasing bonding capacity is not easy and it requires a dedicated effort throughout your organization. Using outside service providers such as bankers, accountants, or bonding agents can be beneficial, as they understand what underwriters look for in contractors. They can also give the surety an extra level of confidence in your company in situations where your service provider is someone they already know and trust.

**Work-In-Process (WIP)**

Surety companies prefer to underwrite contractors who operate with accurate Work-In-Process (WIP) estimates and steady work. Without accurate estimates being reflected in the company’s WIP schedule, the contractor will experience repeated gain or fade on job profitability for financial statement purposes. These gains or fades will cause the surety to question the contractor’s estimating ability, which could have a negative impact on bonding capacity.

A profit fade means the contractor recognized profit too early and must pay for it later. After a surety company bonds a contractor based on a solid financial statement, it doesn’t want to see losses showing up later. In fact, if one project manager has a habit of overly optimistic estimating with resulting profit fades, a surety will notice his or her presence on a new project and discount the company’s bond-worthiness accordingly.

A general contractor might anticipate completing a million-dollar job for $800,000. If it incurs $400,000 in costs the first year — 50 percent of the total — it will recognize 50 percent of the total contract price as revenue, or $500,000. Accordingly, for that year, income minus costs produces a gross profit of $100,000. However, what if next year at job’s end the contractor’s total costs have mounted to $900,000? Its total profit on the job is now only $100,000 — which it has already recognized. The originally anticipated profit margin of $200,000 has now faded to $100,000, and the company will need to report this profit fade in the second year. Accordingly, the gross profit for year two will be zero, since 100% of the total profits on the job were recognized in the first year. In hindsight, the company should have only recognized revenue of $444,444 in the first year ($400,000 divided by $900,000 times the $1,000,000 contract amount) and the balance in year two.

Profit gains are less worrisome and may merely register a firm’s conservative projections. But a construction company’s ability to accurately estimate work is critical, and steady WIP figures offer evidence of that strength.

A surety looks at charge rates, too. If a company charges for certain services at $225 an hour on one job and $325 on another, a surety will probably request more information on why there is a difference. The company’s WIP figure may be undervalued if it’s undercharging for services or equipment.

**Professional Advisors**

The construction industry is characterized by swings in profit margins, available work, cash flows, and labor availability – all of which can have a substantial impact on your company’s profits. Additionally, as bonding requirements become more stringent, it is more important than ever to make sure your package is properly positioned. Advisors can provide a broad range of accounting, process and business optimization services to contractors and subcontractors of all sizes to enhance working capital and maximize their bonding capacity.

**Board of Directors**

If your company has a board of directors, it is an advantage to create a page of the directors with the following information:

- Name of director
- Brief biography on the director
- Role on board, such as subcommittees

**Job References**

Experience is a key factor and bond companies can only recognize a contractor’s experience by verifying successfully completed projects. Get a reference letter on large and more complicated jobs and keep them for future bonding applications.
CONCLUSIONS

All the compliance and planning, however, are not a cure-all. The construction industry can experience inconsistent economic times and bonding companies are more concerned than ever with the contractor’s ability to complete jobs and be profitable in any environment. How then do contractors demonstrate to the surety the ability of the contractor to perform?

Begin by using some of the planning techniques described above, present the most positive financial picture possible, and improve cash flow and properly finance assets. These moves will place the contractor in the best light with the surety from the financial aspect. From the performance viewpoint, a contractor new to the bonding marketplace needs to start small. The only way a surety recognizes the ability to perform is by seeing historical performance. The contractor will not obtain bonding for large jobs in the absence of satisfactorily completing smaller ones. Historical performance cannot be overemphasized when entering the bonding arena.

The bonding environment, much like that of banking and other credit grantors, is more cautious than it has been in many years. Although this has created some new hurdles in obtaining performance bonds, the educated contractor who has shown an ability to perform and who recognizes the importance of timely reporting and properly prepared financial statements that show a sound financial position, will succeed in obtaining bonds.

As discussed, financial statements play a major role in bonding capacity. This set of documents is even more important now that your construction company may have more leverage with its existing bonding provider or another working in today’s strong surety market. For expert help, contact a trusted advisory company. They are well equipped to help you compile and present your company’s financial information in ways that will facilitate a surety’s evaluation. Don’t hesitate to also solicit their advice on how to make your bottom line even stronger.
APPENDICES

Appendix 1: Different Types of Bonds

Bid Bonds
Not all construction projects require bid bonds, but they are frequently requested alongside the financial proposals that contractors provide to clients. If needed, clients will require contractors to obtain a bid bond before they accept the bid and award the construction contract. This bond guarantees that the contractor would enter into a contract for the original amount bid if the contract is awarded. The surety places good faith in the bidding contractor and guarantees the contractor will, upon award, fulfill the contract to the bid terms.

Payment Bonds
The federal Miller Act requires contractors to furnish payment and performance bonds before they can be awarded contracts that exceed $100,000. These bonds are also required for any publicly funded project that includes the alteration or repair of a building that costs $100,000 or more.

Payment bonds ensure subcontractors and material suppliers get paid for their contributions to a project. The financial guarantee provided by a payment bond also keeps the project owner from assuming these costs if the contractor cannot pay. The surety is ultimately liable for reimbursing the unpaid party for their loss by appropriating the surety bond amount. However, indemnification clauses used on bond forms typically outline that the contractor or construction firm will be required to reimburse the surety for the costs associated with claims.

Performance Bonds
Performance bonds are often coupled with payment bonds because both protect the project owner from incurring loss due to contractor shortcomings. Performance bonds ensure quality completion of the project as outlined in the contract. Furthermore, the time allotted to complete construction must also be upheld. If the project takes longer than anticipated or is completed in an unsatisfactory condition, the owner can make claim on the bond. Granted the claim is valid, the bond amount can be used to compensate the owner because the contractor failed to uphold the contract’s terms.

Bonding companies only issue surety bonds to contractors who they believe will uphold contractual terms. As such, qualifying for contract bonds can be a frustrating aspect of the business for many construction professionals. Fortunately, having a general understanding of how contract bonds work and why they’re required allows contractors to better understand the bonding process.
Appendix 2: Key Financial Ratios

Sureties are major users of industry statistics and generally understand the range of ratios which indicate solid financial health and those which indicate trouble for the contractor. You should compute your financial ratios to see how you measure up before you give your statements to the surety. Depending on the specific contractor, specialty, size and type of work they will look for financial ratios in the following generally ranges:

**Common Financial Ratios and Performance Measures**

<table>
<thead>
<tr>
<th>Ratios and Measures</th>
<th>Calculation</th>
<th>2019-2020 Mechanical Contractor RMA Data¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days Working Capital</td>
<td>(\frac{(Current \ Assets - Current \ Liabilities) \times 365}{Annual \ Revenue})</td>
<td>9.2 Days</td>
</tr>
<tr>
<td>Accounts Receivable Turnover</td>
<td>(\frac{Accounts \ Receivable}{Annual \ Revenue} \times 365)</td>
<td>50.9 Days</td>
</tr>
<tr>
<td>Accounts Payable Turnover</td>
<td>(\frac{Accounts \ Payable}{Cost \ of \ Goods \ Sold} \times 365)</td>
<td>54.1 Days</td>
</tr>
<tr>
<td>Current Ratio</td>
<td>(\frac{Current \ Assets}{Current \ Liabilities})</td>
<td>1.6</td>
</tr>
<tr>
<td>Receivables to Payables Ratio</td>
<td>(\frac{Accounts \ Receivable}{Accounts \ Payable})</td>
<td>2.7</td>
</tr>
<tr>
<td>Debt to Net Worth</td>
<td>(\frac{Total \ Debt}{Net \ Worth})</td>
<td>1.5</td>
</tr>
<tr>
<td>Sales to Working Capital</td>
<td>(\frac{Sales}{Current \ Assets + Current \ Liabilities})</td>
<td>9.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ratios and Measures</th>
<th>Calculation</th>
<th>2012 SMACNA Financial Survey²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Fixed Assets to Equity</td>
<td>(\frac{Net \ Fixed \ Assets}{Total \ Equity} \times 100)</td>
<td>21.3%</td>
</tr>
<tr>
<td>Working Capital Turnover Ratio</td>
<td>(\frac{Net \ Sales}{(Beginning \ Working \ Capital + Ending \ Working \ Capital) / 2})</td>
<td>6.44</td>
</tr>
<tr>
<td>Gross Profit Margin Percent</td>
<td>(\frac{Gross \ Profit}{Total \ Sales} \times 100)</td>
<td>19.7%</td>
</tr>
</tbody>
</table>

¹ The Risk Management Association (RMA), “238220 NAICS Plumbing, Heating, and Air-Conditioning Contractors – Single Industry Data,” (November 1, 2019), www.rmahq.org. The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk management principles.

Calculating Your Bonding Capacity

Adjusted working capital is probably the most important criteria in calculating your bonding capacity. Working capital, as previously defined, is current assets less current liabilities (as adjusted by the surety). Generally, your bonding capacity limits can be anywhere from 5 to 20 times your adjusted working capital.

Typically, your adjusted net worth should be 7% to 10% of work on hand to be considered acceptable and when you compute the bonding limits using adjusted working capital and adjusted net worth, you should have the same number.

Once you have analyzed your financial position, you must be prepared to present your case to the surety and to answer any questions their analysis brings to light. For example, questions could be:

- Why do your job profits trend downward from original bid to completion?
- Why is your overhead growing at a rate greater than the increase in volume?
- What are your future plans to maintain profitability?
- Who are the keys to your success?
- How do you see your company weathering future economic slowdowns?
Appendix 3: Techniques to Maximize Your Bonding Lines

As previously discussed, bonding companies typically make a variety of adjustments to a contractor’s financial statement when computing bonding limits. Understanding and anticipating these adjustments can be used to your advantage. The following are some simple but effective techniques to increase your “adjusted” net worth and “adjusted” working capital and improve the overall appearance of your financial presentation especially when getting ready for your annual financial statement.

How to Increase Current Assets to Increase Working Capital

- Make sure your financial statements are in full conformity with the current financial reporting requirements for contractors.
- Liquidity is important to sureties; therefore, high cash balances are critical. Consider holding payables for the last two weeks of the year and make payments on the first day of the next year rather than before your current year to increase cash on your balance sheet.
- Decrease prepaid expenses such as taxes, insurance, etc. by adjusting the coverage dates or payment dates to correspond with your yearend or net prepaids with liabilities.
- Reduce inventories by converting them to contract billings if possible (or underbilled receivables). To the extent you do reflect inventory on your balance sheet, always include a footnote fully explaining its content, marketability and how it was valued.
- Repay officer or affiliate loans receivable before the end of the year even if you have to borrow the money outside of the company. If you have accrued a bonus to the same officers who owe money, make sure they are offset against the loans and not shown as accrued liabilities. If you have other receivables (nontrade), make sure you fully explain them in a footnote.
- Keep unproductive real estate off the balance sheet including leasehold improvements.
- Convert underbillings on contracts to unbilled accounts receivable wherever possible.
- Collect your accounts receivable to increase your cash position. Put in extra effort the last three work weeks of the year to get your receivables collected and in the bank by the last day of your fiscal year.
- Minimize your underbillings as much as possible by overbilling contract at year end and making sure you get your requisitions out before year end. Underbillings are not viewed much more unfavorably than overbillings.
- Cash surrender value on life insurance policies are generally included as current assets by the surety even though they are not reflected as such on your balance sheet. Check with your surety to make sure they classify cash surrender values as such, if not, borrow the cash surrender value out and net the loan.
- Do not make loans or advances to employees.
- Subchapter S withdrawals which are needed for tax payments or other owner needs should be deferred until after year end.
- Keep equipment off your balance sheet if possible. You can use a separate equipment company but be aware of the sales tax considerations. At the very least, defer major purchases of equipment until after year end. You may also consider leasing equipment under operating leases.
**How to Decrease Current Liabilities to Increase Working Capital**

- Deferred income taxes should be reclassified to long term, if possible.
- Eliminate any short-term bank borrowings on lines of credit or convert short-term debt to long-term borrowing if possible. Never use short lease lines of credit to borrow for fixed asset equipment purchases.
- Utilize operating leases on rented or leased equipment rather than capital leases to eliminate liabilities from your balance sheet.
- Notes payable to shareholders should either be paid off, subordinated to the bonding company, or contributed to capital.
- Minimize delinquent payroll taxes liabilities. This will not increase working capital but will ease concerns of the surety.

**Other Suggestions**

- Reevaluate the depreciation methods and useful life span for your equipment to make sure they correspond to the true economic condition and value of the equipment. Longer useful life spans will decrease current depreciation expense and increase earnings.
- If your bank has your receivables as collateral on a line of credit, get them to give you a release or subordination of bonded receivables which will clarify claims on assets in the event a claim is presented to the surety.

These suggestions are intended to assist you in presenting your financial statement in a more favorable light. Above all else, you should never misrepresent your financial situation.