

SMALL CONTRACTOR DEVELOPMENT PROGRAM, INC.

BONDING WORKSHOP

FOR

TRINITY RIVER INITIATIVE AUTHORITY

WHY ARE BONDS SO IMPORTANT



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Surety – the bonding company.

Bidding Public Works Project

Public works agencies require all prime contractors to provide a bid bond, performance bond and payment bonds, and some cases, maintenance bonds when bidding on public projects.

Due to the enactment of several laws these requirements are statutory. Various state and federal laws come into play as far as bonding is requirement for public works projects.

The Heard Act of 1893 was the first such act legislated by Congress requiring contractors to post bonds when working on federal projects. The act was superseded by the Miller Act, placed into law in 1935 and remaining in effect today.

Miller Act required a contractor engaged in work involving federal funds to provide a payment and performance bond on all contract work exceeding \$25,000.

Most states have followed suit and enacted “Little Miller” laws requiring contractors to provide payment and performance bonds for various types and sizes of state or municipal –funded construction projects.

Negotiating with a General Contractor in need of a bondable sub-contractor

There may be times when a qualified, bondable general contractor is at the upper limits of his or her bonding capacity but wishes to submit a proposal on a project requiring a bid bond and a performance and payment bond.

They may be faced with a dilemma – having a marginal amount of bonding capacity available but not enough to meet the needs of the project at hand.

The general contractor may be able to augment their own bonding capacity by engaging a subcontractor who has the ability to bond back portions of their work; thus, allowing the surety of the prime to issue a credit equal to the amounts being bonded back,.

- A qualified opinion – This type of opinion states that accepted accounting and auditing procedures have been followed in all cases except one, two or possibly possible more exceptions, and each exception is spelled out in the letter.
- Disclaimers – when the auditor cannot vouch for certain data or information upon which to base a conclusion, the accountant will state that examination of the client financial statement was limited based upon these uncertainties.
- An adverse opinion – When a CPA is of the opinion that the contractor has not properly presented his or her financial position correctly, this be so stated in a cover letter.

Types of accounting methods used in the construction industry. There are several different accounting methods used by contractors, and bonding companies will scrutinize each method when reviewing a financial statement.

- Cash basis – this method of accounting establishes income when it is received and cost and expenses when they are paid.
- Accrual basis – Using this method of accounting, income is entered when it is earned with no regard for when expenses or costs will be paid.
- Percentage of completion – Income is booked by estimating the percentage of completion of a specific construction contract or contracts when work is in progress. This is the preferred basis of accounting due to the inclusion of cost in excess billings or more commonly called under billing which is an asset and billings in excess of cost or an over billing which is considered a Liability.
- Completed contractor approach – Income is reported in the year in which the construction contract work was totally complete or substantially complete and accepted by the client. Using this form of accounting, all costs associated with the project(s) are accumulated, and when compared with the revenue from the project, creates a profit and loss for that year.

The form of accounting allows the contractor to defer tax consequences, either profit or loss, until the end of the project and not the end of a calendar year.

Bonding companies prefer the percentage of completion or completed contract approach and generally will not accept financial statements prepared on a cash basis for the purpose of underwriting.

any company is a critical issue; in a small company it is crucial. What happens if the present owner dies or is unable to run the company? Who will assume command?

But beyond the obvious, the bonding company would like to ascertain that some plan has been established for future growth of the company – in either volume or profit or both.

An organizational chart of the present management structure will be required and this chart can be used to incorporate potential additions to the staff as anticipated growth occurs.

For example, if one of the current owners is listed as Estimator/Purchasing Agent but the org chart clearly shows an empty space available for either of these positions, it is a clear indication that the company is prepared to grow when the time comes.

The underwriter will be very interested in the company's plan for growth and capacity for additional work since the underwriter is basically concern about corporate stability – both from the management and financial standpoint.

If the company's operations involve ownership and maintenance of expensive equipment, the underwriter will be interested in knowing how the equipment is being used and maintained. For example, the underwriter will want to know if the equipment is owned by the construction company or a subsidiary. If owned by a subsidiary, how is the intercompany relation being entered into the accounting books? Are the owners of the equipment company the same as the ones of the construction company. Cross indemnity may be required from the company that owns the equipment.

Since most construction work is labor intensive and future work depends upon availability of labor, whether a subcontractor is union or nonunion may come into play.

The union contractor have the ability to expand or contract their forces by relying on the union hiring hall to either send them more workers or act as a sponge to absorb excess workers during slack periods. Non-availability of skilled workers will limit the subcontractor's ability to acquire more work. The nonunion subcontractor must be prepared to demonstrate an ability to tap a pool of trained craftsmen if their sales volume suddenly increases

Obtaining That First Bond

Obtaining the assistance of a professional surety producer is the first step, and if the company's in-house financial person is unfamiliar with methods to locate one. They need to make the call to a bond producer.

The time required to secure a bond line is a lengthy process. Bondability is often a key factor in any future business plan and should be considered by all established companies.

- Change orders and executed
- Amount billed to date on uncompleted projects
- Costs incurred to date on uncompleted projects
- Revised estimate of cost to complete the project
- Estimated gross profit
- Anticipated date of completion
- Schedule of general and administrative expenses
- Aging schedules of accounts receivable and payable
- Explanatory notes attached by the accountant to more fully explain anything in these statements that may require clarification or amplification

Indemnity Agreements

Surety bonds guarantee a company's performance and payment of job-related bills and other obligations, and the contractor is expected to fulfill these obligations.

The bond underwriter will require that the company receiving the bond will sign an indemnity agreement that obligates the company to protect the surety from any loss or expense.

This agreement may take the form of a personal indemnification requiring the posting of personal possessions – the owner's house, automobiles, etc.

The purpose of the indemnification agreement is to insure that the company obtaining the bond will stand fast in the face of a problem relating to potential default and make every effort to resolve any difficulties which may cause the bond to be called.

Keep in mind that surety bonding is not insurance. In the insurance industry you buy a policy and you are cover for any loss you may incur as long as it is named in the policy. The surety bond industry is more like banking. They will pay any bills and complete any work that the contractor failed to do, but they will recover any and all cost through back plus attorney's fees through the indemnity process

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