National Association of Surety Bond Producers

NASBP

ANSWERS TO 51 QUESTIONS SMALL CONTRACTORS ASK ABOUT BONDING

A SuretyLearn Publication

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The National Association of Surety Bond Producers (NASBP) and its membership know that small and emerging contractors seeking to obtain surety credit and grow their businesses have many questions about that process. In order to provide simple, straight-forward answers to complex questions, NASBP has created this program, which contains short answers to 51 of the questions most frequently asked by small and emerging contractors. While this program may not answer every question you have, it will certainly answer many of them.

If you still have questions, and you probably will, NASBP invites you to visit its website SuretyLearn.org, which NASBP developed to provide valuable information to small and emerging contractors on how to position their businesses to achieve surety credit. The SuretyLearn.org website has many resources, including a link to an online bonding orientation course; informative articles, checklists, questionnaires and slide presentations; links to government agencies and pertinent assistance programs; and a directory of NASBP surety bond producers who specialize in serving small and emerging contractors.

NASBP urges you to contact your local surety bond producer for more information. Don't have a bond producer yet? Please see the Answer to Question #4 below, which tells you how to find a professional surety bond producer in your area through NASBP's online membership directory.

NASBP gratefully acknowledges the members of the NASBP Small and Emerging Business Committee and the participants on the NASBP CPA Advisory Council, who drafted the answers for this program.

1 What is a surety bond?

A surety bond is a promise to be liable for the debt, default, or failure of another. A surety bond is a three-party contract by which one party (the surety) guarantees the performance of a second party (the principal) to a third party (the obligee). Surety bonds that are written for construction projects are called contract surety bonds. (Otherwise, they are called commercial surety bonds.)

The **surety** is a company licensed by a state department of insurance to provide surety bonds to third parties to guarantee the performance of a principal.

The **principal** is the person or entity (in construction, the contractor or subcontractor) on whose behalf the bond is given. It is the principal's obligation that the surety guarantees.

The **obligee** is the individual or entity with whom the principal has a contract and to whom the bond is given. In construction this is the project owner or the prime contractor.

If the owner is the bond obligee, then the prime contractor is the principal. If the prime contractor is the obligee, then the subcontractor is the principal.

2 Are surety bonds like traditional insurance policies?

No. Surety bonds are almost always written by insurance companies that are licensed by state insurance departments, but they are not like traditional insurance policies. Surety bonds are three-party agreements, and traditional insurance policies are two-party agreements, such as life insurance policies or property insurance policies. The surety does not "assume" the primary obligation, but is secondarily liable, if the principal defaults on its bonded obligation.

A surety does not expect to suffer losses because the surety expects the bonded contractor to perform its contractual obligations AND the surety has a signed indemnity agreement from the contractor to protect it from any losses the surety suffers as a result of having issued the bonds. This means that, if a surety incurs expenses and/or pays out as a result of a claim(s), the bonded contractor (or any other of the indemnitors) must reimburse the surety.

3 What are contract surety bonds?

Bonds written by a surety company for construction projects are referred to as contract surety bonds. The four main types of contract surety bonds are: bid bonds, performance bonds, labor and material payment bonds (generally called payment bonds), and warranty bonds.

The two basic functions of these bonds are:

- Prequalification—assurance that the bonded contractor is qualified to perform the contracted obligation
- Financial protection if the contractor defaults on its obligation—guarantee that the contract will be performed and certain laborers and suppliers will be paid for work and materials

4 Who do I go to in order to get a bond?

As a contractor, you are now ready to position your business to obtain surety credit—to qualify your construction business to get bonds and to grow your business. The first thing you need to do is contact a professional surety bond producer and start developing that relationship.

Bond producers are business professionals who specialize in providing surety bonds to contractors, subcontractors, and other construction project participants. They are knowledgeable about the surety and construction markets and focus their main activities on the surety market and position construction firms to qualify for surety credit. They provide invaluable business advice and expertise to assist a contractor in securing its surety credit relationship and increasing its surety credit, if appropriate. They obtain from the contractor information and documentation needed by the surety to evaluate a request for bonding. They nurture a successful relationship between the contractor and the surety company. They develop and maintain with the contractor a relationship of trust, commitment, respect, and teamwork.

How do you find a professional surety bond producer in your area? The National Association of Surety Bond Producers (NASBP) is a national trade association of bond producer agencies, whose employees are experts in surety. Names of these professionals specializing in surety bonds can be found in the NASBP membership directory. Go to the membership directory on the NASBP website **www.nasbp.org and click on "GET A BOND"**. The producers are listed by state.

5 How do I plan for my first meeting with a surety bond producer?

You will probably be both excited and anxious about your first meeting with your bond producer. As much as possible, bring to the meeting all the information, statements, and reports requested by the bond producer in the checklist he/she sends you. You may not have every document or all the information requested. If not, you and your producer can work out a game plan during the first meeting to obtain such information.

Your first meeting is mostly about the bond producer learning more about you and your business history and setting the stage for moving forward to meet your business's surety goals.

You should bring to the first meeting information that demonstrates organizational structure, experience, and financial wherewithal. At a minimum a contractor should bring the contractor's questionnaire and financial statement. Resumes, brochures, letters of recommendation and/or accomplishments and CPA-prepared financial information always make a strong statement of commitment to your business. For more information on what to bring to the first meeting, see Q&A #6 below.

6 What documents will the bond producer ask me to bring to our first meeting?

Often bond producers will send a contractor a checklist before their first meeting, requesting that the contractor bring certain listed information to the first meeting. The checklist might include the following requested information:

- Past 3 fiscal year-end financial statements
- Current interim financial statement and aging receivables and payables report
- Copies of any bank loan agreements, including lines of credit and recent line of credit statement
- A current personal financial statement
- A current statement of work in progress
- Resumés of owners/key employees
- Letters of recommendation about the accomplishments of your company
- A statement of qualifications for the company
- Certificate(s) of insurance
- A contractor's questionnaire, which requests detailed personal and company information, including:
  - Business information and details, including articles of incorporation
  - Officer information
  - Financial and bank information
  - Key personnel
  - Surety relationship, if any
  - Largest completed contracts
  - Trade references
  - Life insurance information
  - Specimen copy of subcontract agreement

7 What can I expect at my first meeting with my bond producer?

At a contractor's typical first meeting with a bond producer, the bond producer will spend a good deal of time listening to and understanding the history of the contractor's business, company ownership, project expertise, operations, and goals/desires for bonding.

The bond producer will explain whom he/she works for, how surety companies underwrite bonds, how bond rates work, how to request a bond, the importance of a good construction accountant, why bond underwriters care about construction accounting and bank support, how he/she can add value to coaching the contractor to obtain higher levels of surety capacity, and the general lay of the land in the surety marketplace.

8 What is a bid bond and what does it do?

A bid bond provides financial protection to the obligee (who can be the owner when the general contractor provides the bonds, or the general contractor when the subcontractor provides the bonds) if a bidder is awarded a contract but fails to sign the contract or fails to provide the required performance and payment bonds. The bid bond also helps to screen out unqualified bidders, as a surety will not issue a bid bond on behalf of a contractor that it believes cannot fulfill the contract obligation. Prequalification means that the surety has investigated the contractor and determined that the contractor has the ability to carry out the work under the construction contract.

The surety's specific obligation under the bid bond is set forth in the bond itself. The surety is usually obligated to pay the owner the cost of having to repeat the bid process if the awarded bidder is unable or unwilling to perform. The surety's liability is generally limited to the face amount, or penal sum of the bond, which is in the range of 5 to 20 percent of the contract price.

9 What is a performance bond and what does it do?

A performance bond provides an obligee with a guarantee that, in the event of a contractor's default, the surety can be called upon to complete or cause to be completed the contract in accordance with the plans and specifications. Bonds differ in terms of the types of options available to the surety, and to the obligee, in the event of a default.

If the bonded contractor fails to perform its work in accordance with the plans and specifications, the owner, which has performed its contractual obligations, has a right of action against the surety to obtain completion of the contract and enforce the owner's rights under the contract.

10 What is a payment bond and what does it do?

A payment bond ensures that certain subcontractors and suppliers will be paid for labor and materials incorporated into the project, if the bonded principal fails to pay for labor and materials supplied for the project.

A laborer or supplier that has a right to make a claim against a payment bond is referred to as a "claimant." Who is a proper claimant under a payment bond is typically restricted or limited by statute, the contract, or the bond.

Most payment bonds require a claimant that does not have a contract with the principal to give the principal or surety, or both, written notice of its claim within a specific period of time after furnishing the labor or materials for which the claim is made. It is critically important to meet these deadlines, in the bond or any statutes governing the bond, or the claimant will lose its rights under the bond.

11 What is a warranty bond and what does it do?

A warranty bond (sometimes called a maintenance bond) guarantees the owner that any work defects found in the original construction will be repaired during the warranty period. They are typically used when an owner wants a warranty period beyond one year. A warranty period can be extended for an annual fee, but sureties are reluctant to go beyond a few years. If the contractor is unable to resolve the warranty issue or is not in business during the specific warranty period, the warranty bond provides the owner with a remedy. The annual fee for a warranty bond is a fraction of the cost of a performance bond.

12 Are bonds required on public projects or private projects, or both?

Contract surety bonds can be required by the federal government, state governments, local governments, private owners, and general contractors.

Under the federal Miller Act and certain regulations, any federal construction contract valued at $150,000 or more requires a performance bond and a payment bond. Each state has a "Little Miller Act," similar to the federal Miller Act, which requires a performance bond and a payment bond for state contracts over a certain amount, called the bond threshold. Many local jurisdictions have their own public works performance and payment bond requirements.

In the private sector, there is no mandate for the use of bonds on construction projects. Understanding the value of contract surety bonds, however, many private owners choose to require contract surety bonds on their projects for the same reasons the government does: to ensure the contractor is qualified to perform the contract, to ensure the contract will be completed in accordance with the plans and specifications, and to ensure that certain subcontractors and suppliers will be paid. In the same manner, as a risk management tool, prime contractors will often elect to require that their subcontractors obtain performance and payment bonds. Sometimes lenders require owners to obtain bonds on projects as a condition for receiving financing.

13 I already have my license bond. Why do I need performance and payment bonds?

Contractor license bonds are required by most states and some localities to guarantee that a contractor will operate its business in compliance with the rules and regulations regarding its specific contractor license. A contractor license bond does not guarantee a specific contract.

Contractor license bonds are not the same as performance and payment bonds. They guarantee compliance with a state or local contractor's license and do not guarantee a specific contract. On the other hand, performance and payment bonds guarantee that a specific contract is fulfilled according to the plans and specifications and that certain subcontractors and suppliers are paid.

14 Why do I have to get performance and payment bonds when they protect everyone else but me?

While it is true that bonds do not protect contractors on whose behalf the bonds are written, they do protect the owner that wants the work performed. Bonds are a requirement that the owner imposes on a contractor to protect itself against contractor failure and the contractor's inability to pay its bills. For example, if a developer is building some office buildings, it wants to hire a contractor that has the history, experience, and financial capabilities to complete the work. The owner has little or no ability to prequalify the contractor, so it requires a performance and payment bond that gives it the assurance that, if the contractor does not perform the work properly or pay its bills, the surety is standing behind the contractor to step in to complete and pay bills due and owing.

15 Can I just get a blanket bond to cover all my surety bond needs?

Because contract bonds—bid, performance, and payment bonds—follow a specific contract/obligation, each bond is issued for that particular purpose on a case-by-case basis. A contractor's bond producer and surety underwriter review the contract documents, especially the scope of work, and make sure that the work under the contract fits within the contractor's normal abilities and capabilities.

16 What is the cost of the bonds? Are there ever adjustments to the bond premiums based on the final contract price?

The cost of a bond is based on rates filed with the state insurance department. The cost of a bond can vary, from less than 0.5% to as much as 3%. For a small and emerging contractor with minimal experience, a contractor can expect the rate to be between 2-3%. There are always adjustments to the bond premiums based on the final contract price. If the price increases, there's an increase in premium; and if the price decreases, the premium is reduced as well. A contractor should always include the cost of its bond in all proposals and in its change orders, no matter how small because bond premiums are typically reimbursed. Several small change orders over time can turn into a large increase in the contract, which will result in an increase in premium. A contractor wants to avoid the premium coming out of its profit.

If a surety requires a U.S. Small Business Administration (SBA) guarantee or funds control/escrow as a condition of approval, the cost of the bond can increase up to an additional 1% of the total contract price. These fees are paid to the SBA and/or escrow company and are in addition to the premium paid to the surety.

17 The bid bond is only 5% of the total contract. Why am I being evaluated for a bond the size of the entire contract?

The bid bond is both a percentage of contract security and evidence of prequalification for the ultimate contract value. Thus, consideration of the full contract amount on bid day is necessary at the same time the bid bond is being considered. If the contractor is deemed qualified to perform the contract, the bid bond is issued. If the contractor is deemed unqualified to perform the work, the bid bond will not be approved, notwithstanding that the bid bond is only a small percentage of the contract amount

18 When are bond premiums typically paid?

The performance and payment bond premium becomes due and payable on the execution of the bonds and the underlying contract. Once the bonds are issued, they are binding.

19 What factors does a surety consider in the underwriting and prequalification process?

Contractor prequalification, as performed by surety underwriters, involves a thorough and continuing process for reviewing and evaluating balance sheets, work-in-progress schedules, and financial statements. Surety underwriters also evaluate factors such as the risk under the specific contract for which the contractor seeks a bond, the contractor's entire work portfolio, past performance, experience, operational efficiency, managerial skills, business plan, and reputation for integrity.

Obtaining bonds is more like obtaining bank credit than purchasing insurance. Different sureties will stress varying factors during the underwriting process, but almost all will consider the following factors:

- ✔ Financial capacity
- ✔ Net worth
- ✔ Cash flow
- ✔ Assets
- ✔ Credit score
- ✔ Work in progress
- ✔ Work history, including expertise and experience
- ✔ Banking relationship
- ✔ Nature of project to be bonded
- ✔ Character of the contractor

20 Why is financial statement reporting of small contractors so important to surety companies and banks?

Small contractors will eventually be required to provide their bank and surety financial statements in order to obtain a bank line of credit or to obtain bonds for a project. The accuracy and proper presentation of this financial statement is critical to ensure that the contractor maximizes the amount of credit extended by its bank and surety. A contractor's financial statements tell the story of where the contractor is from a financial perspective, and the banks and sureties use this information to perform their underwriting processes. A poorly prepared financial statement that is not up to industry standards with regard to form and content will reflect poorly on the contractor and could lead to rejection of credit by the bank and surety, as they will have concerns about the accuracy and completeness of the financial presentment.

21 What are the best practices and key items that banks and sureties are looking for when they receive a financial statement?

First, the financial statements should be prepared in accordance with Generally Accepted Accounting Principles (GAAP). GAAP has very specific rules as to how revenues and expenses are treated and how various assets and liabilities are presented. For contractors that may have used the cash method of reporting their results, they will need to adjust their numbers to GAAP, which will generally require their construction contracts be reported on the percentage of completion method for revenue recognition. The financial statements presented should generally contain a balance sheet, an income statement, a statement of cash flows, and footnote disclosures explaining in more depth the contractors and the various items reflected in their financial statements. Also, a work-in-progress (WIP) schedule that details the status of the contractor's various projects related to revenues, billings, costs, gross profit, over/underbillings is generally requested. Banks and sureties may accept a balance sheet and income statement prepared in-house by the contractor without the statement of cash flows, footnotes, and WIP schedules; but as the bank and surety credit lines increase, the contractor will typically be required to provide a certified public accountant (CPA) compiled or reviewed financial statement.

Small contractors should make sure that, as they grow, they are working with a qualified CPA who is familiar with construction industry reporting and with what the banks and sureties are looking for.

22 Why does unbonded work count in my program?

When qualifying a contractor for bonding, surety companies use a variety of criteria, including measurements of financial strength and liquidity/solvency. A surety company will compare a contractor's liquidity and net worth to the amount of work-in-progress the contractor has in order to get a sense of how leveraged that contractor's balance sheet is compared to its contractual commitments. In doing so, surety companies include both bonded and unbonded projects in their analysis and calculation of a contractor's bond program because both kinds of projects require working capital and use resources, which affects a contractor's ability to take on and perform additional work.

23 What is a general agreement of indemnity?

A general agreement of indemnity, or GIA, is a contract between a surety company and a contractor. The GIA is a powerful legal document that obligates the named indemnitors to protect the surety company from any loss or expense that the surety suffers as a result of having issued bonds on behalf of the bond principal. Therefore, under a GIA, if the contractor fails to fulfill its bonded obligation on a project, and the surety suffers any loss, the indemnitors are legally bound to indemnify, or pay back, the surety for its losses. The surety's losses include what is paid to finish the project and the expenses associated with the surety's diligence in investigating the claim itself.

A fundamental concept of suretyship is that the surety will not sustain a loss. The surety expects to be indemnified (that is, paid back) and reimbursed for any payments or losses by the principal and indemnitors under the indemnity agreement so that the surety has no ultimate loss. Therefore, the GIA is almost always signed and delivered to the surety before the surety will issue any bonds on behalf of the principal. The GIA will apply to all bonds issued by the surety for the principal.

A GIA is a standard document in the construction and surety industries, which provides a surety issuing bonds with many enforceable legal rights against the indemnitors that signed the GIA. Contractors should be aware, however, that there is no standard indemnity agreement and that the language of GIAs varies from surety to surety; and few sureties will negotiate the terms of their specific GIA. Before signing a GIA, a contractor should review and understand it to ensure there are no provisions in the GIA that are too risky to the business. Courts will readily enforce the unambiguous provisions in GIAs.

Prudent contractors should consider seeking advice from knowledgeable legal counsel before signing a GIA.

24 Who typically signs the general agreement of indemnity?

If a surety company decides that a contractor should be extended surety credit, the surety company will typically require that the contractor, as well as others, sign a GIA before it will issue bonds on behalf of the contractor.

A surety company that issues bonds on behalf of a contractor almost always requires that the principal, the individuals who own and/or control the company, their spouses, and often affiliated companies sign the GIA. Both the principal and the third-party indemnitors can be individuals, small business entities and partnerships, and large international corporations.

25 Why do I have to sign the general agreement of indemnity personally, and why does my spouse have to sign the general agreement of indemnity personally?

Surety companies often require the personal guarantees of construction company owners and their spouses, in addition to corporate level guarantees, on GIAs for several reasons. As with loans from a bank, bonds are an indemnification product, where the contractor agrees to indemnify (that is, hold harmless or pay back) a surety company for any claim amounts or costs paid out on bonds issued for that contractor. Oftentimes when a surety has to pay a bond claim and seek repayment, the bonded construction company has defaulted and is either insolvent or bankrupt. What assets are left are typically being claimed by multiple creditors and not just the surety company, all of whom will most likely have to settle for pennies on the dollar in bankruptcy litigation. Thus,

in order to ensure they are repaid, surety companies also require personal guarantees from construction company owners in order to seek repayment from their personal assets for the guarantees the bonding company provides.

Spouses of construction company owners are asked to sign personally as well, primarily for two reasons. First, a bonding company seeks a spouse's guarantee, even if he or she is not involved in the company, in order to prevent the transfer of assets to a spouse that might otherwise have been used to repay the surety company for a loss from a bond claim. Depending on the marriage property laws of the state in which a contractor is located, a bonding company may need a spouse's signature in order to have full access to a contractor's personal assets. Additionally, a spouse's guarantee also helps a surety company prevent or mitigate the potential transfer of company or personal assets to an ex-spouse during a divorce settlement when those assets were being used to guarantee bonded projects.

26 What is construction work in progress and what are its main components?

Construction work in progress consists of all uncompleted construction projects that a company is currently performing. Completion is defined as being BOTH 100% billed and having $0 in costs left to complete on a project. Work in progress is made up of four main components: (1) total contract price (including any change orders to date); (2) total estimated cost; (3) total amount billed to date; and (4) total cost incurred to date. Using those four figures, a schedule of completed and uncompleted contracts can be prepared, which details various earned profit and revenue calculations, percentage completion estimates, and under- or over-billing situations on each project.

27 What is cash flow management and why is it important?

Cash flow management is the process of planning the organization and control of cash movement, both incoming and outgoing, within a company. Even profitable construction companies can have cash flow problems. Contractors should manage the company's overall cash flow, as well on the cash flows on its projects. Proper cash flow management helps contractors make better use of budgets, use capital more effectively, and increase revenues and profits. It can also help make the company more efficient and more desirable to bankers, sureties, and other business partners.

28 What are some of the factors that cause cash flow problems and what are some action steps that construction companies can take to improve cash flow?

Cash flow problems can be caused by a number of factors. Careful planning can help identify small problems before they become bigger, and adopting some simple cash management strategies can help contractors manage and control cash flow. Some such problems and strategies include the following:

1. Not having standard procedures to issue payment requisitions on a timely basis will impact positive cash flow. This cycle is to some extent within a company's control.
2. Payments made to suppliers or contractors before receiving cash payment from the related project. Plan the way a job will be billed before it starts.
3. Retainage. When bidding a job, evaluate the cash flow impact of payment terms and retention release provisions. Negotiate appropriate changes before the contract is signed.
4. Cash purchases of fixed assets. Contractors should carefully consider whether leasing or financing equipment will generate a more positive cash flow than cash purchases.
5. Time lags between billing and collection of receivables. Slow payers need to be reminded that they owe you money. Delays in collecting payments for work performed can weaken a company's working capital position.
6. Not closing out completed projects. This results in final change orders not being resolved and holds up payment of final requisition and retainage.
7. Overstock of inventory. A contractor should avoid maintaining excessive inventory.

Cash flow management is essential if a business is to survive and thrive.

29 I'm a small contractor. Why do I need a construction-oriented CPA?

A contractor knows a lot about concrete, reinforcing steel, drywall, electrical panels, asphalt, etc.; but, in the majority of cases, he/she needs assistance with the financial reporting requirements of the company, as well as tax planning and compliance obligations.

A construction-oriented certified public accountant (CPA) stays up to date in accounting and tax matters having to do with a contractor and imparts sound financial, tax, and management counsel to the contractor. The sections of the Internal Revenue Code that pertain to contractors, as well as the Generally Accepted Accounting Principles that apply to the process of revenue recognition for a contractor, make it indispensable for a contractor to use the services of a CPA with deep knowledge and experience in the subject matter.

For a contractor, surety bonding is an important part of his/her business. The contractor's ability to obtain payment and performance bonds makes the difference between getting public jobs and many private jobs, or not. In turn, obtaining this surety credit is greatly facilitated by having properly prepared financial statements and by making sound business decisions with the advice of a construction-oriented CPA.

A good construction-oriented CPA usually knows the sureties and the surety bond producers (and they know the CPA), as well as the banks that are friendly to contractors. This familiarity and trust brings an additional level of credibility to the contractor's table and, invariably, turns into more surety and/or bank credit.

In an environment of difficult margins and aggressive competition, construction contracting is a difficult enough business; and the advice of an experienced construction-oriented CPA is a necessary part of the contractor's resources.

30 What are the main construction accounting methods, and what are the differences between them?

Two methods of accounting for contractors are generally accepted under accounting guidelines: (1) the completed contract method; and (2) the percentage of completion method.

The **completed contract method** is only allowable in circumstances not resulting in a significant variation from the percentage of completion method. Under the completed contract method, all costs and revenue recognition are deferred until the contract is completed. This method is recommended where estimates are unreliable; it is contradictory to what a surety professional would typically require. It likely only applies to home builders and to contractors with seasonal work, or for contracts started and completed within the same fiscal year.

The **percentage of completion** method of accounting for contractors is preferred and is more likely to be demanded by surety professionals. Using this method presumes that a contractor has the ability to make reasonable cost and revenue estimates and that the owner is expected and able to satisfy obligations under the contract. There are different ways to determine percentage of completion. Generally, the cost-to-cost method is used.

Estimation of revenues on a contract can be complex. Key items include the original contract price, contract options, change orders, claims and provisions for acceleration payments, and liquidated damages. All must be considered to arrive at an adjusted contract price. The percentage of completion, multiplied by the adjusted contract price, establishes the amount earned as of the financial statement date. While a more in-depth discussion around the appropriate treatment of these contract adjustments would be needed, surety professionals will watch for the clarity of the disclosure in the financial statements and analyze how reliable the contractor has been in the past.

31 What is a financial statement and why is it important?

A financial statement is the main source of information about a contractor's financial position, its performance, and changes in its financial position. It is important because a contractor's financial statements provide users with the information necessary to make economic decisions about the contractor. The financial statement is used by bankers, sureties, vendors, investors, and others to make assessments about the contractor's future risks and potential and to establish benchmark trends and relationships. They provide the basis for obtaining credit, setting capacity limits, and identifying investment opportunities. Users rely on data within the financial statements and data that can be derived from them to make their judgments, among which are:

- Working capital – current assets less current liabilities
- Net worth – owners' investment in the contractor
- Debt to worth – measure of the contractor's financial leverage
- Activity ratios – measure of how the contractor uses its assets
- Coverage ratios – measure of a contractor's ability to meet its obligations
- Contract/revenue backlog – amount and quality of the contractor's uncompleted work

Clear and concise footnote disclosures are key components to a quality financial statement, providing a road map for the user to properly interpret the information in the contractor's financial statement.

32 What are the differences between the three services involving financial statements: compilation, review, and audit?

CPAs offer three financial statement services based on the level of assurance that a contractor might require. A **compilation**, the lowest level of assurance, is when financial statements are compiled based on information provided by the contractor. Although a CPA looks over the statements, the CPA does not give any assurance to the validity of the original figures. While this information is generally sufficient for smaller, privately owned companies, it is likely not enough when third parties become involved.

The next level up and the most commonly used is the **review**. During a review, the CPA will take a deeper look at the contractor's financials to make sure that no material modifications need to be made. Once a review is complete, the CPA will conclude that he/she is not aware of any significant changes necessary to the financial statements. Because of this conclusion, and the required independence of the CPA during a review, many creditors and regulatory agencies require review-level assurance before working with a contractor. Many owners also find this level of assurance helpful if they do not manage day-to-day operations of their organization.

An **audit** is the most comprehensive service, providing the highest level of assurance that a contractor's financial statements accurately reflect its financial position. An audit takes the review one step further by not only looking at specific transactions, but also verifying them with sources outside the organization to assess accuracy. Not all contractors will need the extensive assurance of an audit, so it is always beneficial to confer with a CPA, and your surety bond producer, to determine the right level of financial statement preparation that will be needed.

33 What is the difference between a balance sheet and an income statement?

While the balance sheet and the income statement are both important financial statements for a business, they differ in terms of time frame and content.

A **balance sheet** is a summary of a company's financial balances as of a specific moment of time (such as of 12/31/__). Its content shows assets, liabilities, and shareholder equity (net worth); and the values expressed are only accurate as of that stated specific date. In simpler terms, the balance sheet gives a snapshot of what a business has and what it owes as of right now.

The **income statement**, also known as a profit and loss statement, includes content that shows revenues and expenses over a period of time (such as Q1 20__ or annual statements over the entire year). The income statement includes revenues less expenses to show net income. Income statements are helpful in evaluating how much a company has earned or lost over a period of time.

34 Why are pending bids or proposals counted against my work program/ backlog?

Many contractors over the past few years have seen increases in the volume of work On which they are proposing, and in many cases successfully winning, which results in increasing revenues. This increase in activity can cause a contractor to experience growing pains very quickly, whether it's project management, skilled trades, equipment needs, or working capital. One of the key aspects of managing this growth is the support from your surety and bonding program. Remember that a construction bond is not like a traditional insurance policy. A contract bond is usually in place to guarantee payment and/or performance of the construction company for a specific contract.

A key risk that the surety must evaluate is the total commitments that a particular construction company has entered into, or plans to enter into. Therefore, pending bids/proposals must be considered by the surety in evaluating the overall credit risk profile for a construction. It is important for contractors to have early and frequent discussions with their surety to limit surprises and to help the contractor appropriately manage increases in contract activity.

35 What are the various allowable income recognition methods available to small contractors?

Contractors should understand that they have two sets of books potentially, the books to report their financial results to their bank and surety (financial statement reporting) and the books to report and pay their taxes on (tax basis reporting). This answer is going to focus on the tax basis reporting options, as contractors from a best practice perspective should always reflect their financial statement reporting of construction contracts using the percentage of completion method.

Generally, construction contractors are required under Internal Revenue Code (IRC) Sec. 460 to use the percentage of completion accounting method for their long-term contracts. There are exceptions to this requirement, and one of them is the contracts of "small contractors." To qualify its long-term construction contracts for the small contractor exemption, a contractor must meet all of the following conditions:

- The contract is a construction contract.
- The contract is estimated at commencement to be completed within two years.
- The contractor's average annual gross receipts for the three preceding tax years do not exceed $10 million (this should include all gross receipts, not just contract receipts).

The small contractor's exemption must be determined on a contract-by-contract basis. For example, a contractor may have average annual gross receipts of $8,000,000 and be awarded five new contacts during the year. Four of the five contracts are expected to be completed within 12 months, but the fifth contract is expected to last 36 months. The first four contracts would be eligible for the exemption from using the percentage of completion method, but the fifth contract would be required to use the percentage of completion of method under IRC Sec. 460.

The tax accounting methods available for contracts that qualify under the small contractor's exemption are the following:

- Cash method
- Accrual method
- Accrual with deferral of retentions method
- Completed contract method
- Exempt percentage of completion method

36 What are some of the key differences among the tax accounting methods available for contracts that qualify under the small contractor's exemption?

Cash Method

Under the cash method, income is recognized when actually or constructively received; and expenses are deductible in the year paid. Contractors need to be aware that they cannot omit receipts by neglecting to send billings at year-end or asking the owner to delay payment. Also, C Corporations cannot use the cash method once their average annual gross receipts exceed $5 million.

Advantages: Deferral of income until cash is received.

Disadvantages: Could have spikes in taxable income the next year if timing of receipts is accelerated in the following year.

Accrual Method

Under this method, amounts are included in income when earned (billed) and costs are deductible when incurred.

Advantages: Matching of income/expenses is simple. If contractor is typically underbilled, then costs can be deducted before income is recognized (although this is a bad business practice and harmful from a cash flow perspective).

Disadvantages: A contractor with aggressive billing practices (good for cash flow) may be reporting income earlier than under the percentage-of-completion method. Income reported may not be that different than under the percentage-of-completion method.

Accrual with Deferral of Retentions

A common variation of the pure accrual method is the accrual with deferral of retainage. Under this methodology, a contractor can exclude from income retentions receivable until the retention is billable under the contract (basically exclude the unbilled retention balance). Additionally, if recognition of income on unbilled retention is deferred, a contractor must also defer the deduction of subcontractor retention payable. For subcontractors this is a good method as subcontractors typically have unbilled retentions receivable (deferral of income) but little in the way of subcontractors retentions payable.

Advantages: Contractors have the ability to defer unbilled retentions receivable, which for many subcontractors will result in a greater deferral of income than the completed contract method (see below).

Completed Contract Method

Under the completed contract method, recognition of contract revenue and deduction of contract costs is deferred until the contract is complete (deferral of gross profit until project completion). The IRS definition of when a contract is complete is when a contract is 95% complete (cost to cost) and the customer is using the subject matter of the contract for its intended purpose or when final completion and acceptance of the subject matter of the contract takes place.

Advantages: Allows the contractor to defer 100% of gross profit on contracts until the contracts are completed, improving cash flow as taxes aren't paid until job completion.

Disadvantages: Proper planning required if a number of projects completed in a single year. As taxable income could be substantially higher than financial statement reporting income, contractors need to understand deferred tax liability and make sure they don't spend all the cash received from earlier billings and not have sufficient funds to pay tax liability when projects completed.

Exempt Percentage-of-Completion Method

Although not required to use percentage-of-completion accounting, small contractors may use the percentage-of-completion method of accounting with the following exceptions:

- Large contractors must use total contract costs incurred divided by total estimated contract costs to calculate overall percentage of completion.
- Small contractors can use this methodology but also can use other measures such as labor costs to date to total estimated labor costs, direct labor hours to date to total estimated direct labor hours, and other methods that consistently capture overall level of completion of the project.

Advantages: Allows for recognition of profits as work is performed, which could even out tax liabilities. Allows potentially for the same method of reporting contract profits as for financial statement reporting (that is, labor costs to total estimated labor costs), which eliminates requirement to do separate calculations for financial statement and tax reporting.

Disadvantages: Biggest disadvantage is cash flow as income cannot be deferred until the completion of contracts, which will require the payment of taxes in each year of the contract.

37 What are alternative minimum taxes and what do I need to know about them?

The IRS requires contractors to calculate alternative minimum tax (AMT) by using the percentage of completion method using the total costs incurred to total estimated costs incurred method. Accordingly, if a small contractor uses one of the above alternatives, it may be subject to an adjustment for AMTs. The IRS allows an exemption from AMT taxes for C Corporations that have average annual gross receipts less than $7.5 million for the preceding three tax years. This exemption only applies to C Corporations, and S Corporations may be able to defer profits using one of the above methods but the shareholders of the corporation will have an AMT adjustment on their K1 to show the additional profit from contracts under the cost-to-cost percentage of completion method.

38 Will pulling a credit report lower my credit score?

When applying for surety credit, a contractor should expect the surety will evaluate not only business credit, but also credit of individual owners and spouses. Most sureties make a "soft" inquiry, which does not adversely affect the credit score. If the contractor is concerned, he/she may have the surety bond producer request that the surety not evaluate credit until the remaining underwriting has been completed and the surety is prepared to make an offer conditioned upon acceptable credit scores.

39 What can I do if I am declined because of my credit score?

When a surety declines an applicant based upon credit score, it must send the applicant a letter containing the contact information of its credit reporting service. The applicant may contact the credit reporting services for a free copy of its credit report, per the Fair Credit Reporting Act. It is a good idea for the applicant to review this report for any inaccuracies that could be negatively impacting the credit score. If the report contains legitimate obligations, the applicant is encouraged to pay the creditors and maintain a low debt position with timely payment history. In the meantime, the contractor may qualify for some level of surety credit through the U.S. Small Business Administration Bond Guarantee program.

40 How much money do I need to have in order to obtain bonds?

Sureties typically require roughly 10% of the requested bonding program in working capital. Working capital is defined as adjusted current assets minus current liabilities, so it is not necessarily just cash. A professional surety bond producer can assist the contractor with evaluating its working capital position.

41 Why do I need a strong banking relationship?

There are many reasons that a contractor should have a strong relationship with a banker who truly understands the construction industry. There will often be unforeseen circumstances that will interrupt the flow of payments to both prime contractors and subcontractors. Construction is an unpredictable business that carries substantial risk of unanticipated payment delays. Access to capital when you need it is critical to the day-to-day operation and survival of all contractors, large and small, whether it is a line of credit to cover short-term needs or term loans to finance equipment.

A good banking relationship is critically important in order for a contractor to obtain bonding. A banker who specializes in developing relationships with small construction firms can assist such firms to improve their credit position in order to qualify for loans and qualify for surety credit. They can also help clients manage their finances in the most successful way possible and help them navigate numerous other services and products, including online banking, lines of credit, credit cards, and more.

Contractors should establish a good relationship with a banker before needing a loan or seeking surety credit. Before issuing a bond, a surety company wants to know that the construction firm has an established bank relationship and a line of credit. Choosing the right banker can have a big impact on the success of a small construction firm.

42 What is funds administration and why is the surety company requiring it as a condition of issuing bonds?

Funds administration, also called funds control and funds management, is a method that sureties use to offset the possibility of claims against a payment bond. A surety company either hires a third party or uses a subsidiary of the surety company to be the funds administrator.

The use of funds administration on a project can mean that a contractor that would otherwise not qualify for a bond can pursue certain bonded projects and learn how to manage cash flow and project funds. If a surety can mitigate its payment risk, it is more likely to issue bonds on behalf of a contractor.

Once the bonded contract that will be funds administered is awarded, the funds administration services agreement is signed by the contractor/principal, the funds administrator, and the surety. The agreement provides that the funds administrator establish a separate bank account in the contractor's name, receive directly all contract proceeds from the owner, and disburse payments, as well as overhead and fees, during the course of the project.

43 Why do I have to post collateral in order to obtain the bonds?

Collateral is an asset that is pledged by a contractor to secure a surety bond. It is a form of asset that is readily convertible to cash. Collateral may be in several forms, such as a bank account or a bank's irrevocable letter of credit. Because of the uncertainty in today's real estate market, collateral in the form of a deed of trust against real estate is a less desirable form of collateral to sureties.

Surety companies have different underwriting standards. Sometimes a surety company requires collateral from a contractor that is considered a higher risk in order for the contractor to qualify for surety credit. A higher risk principal might have insufficient personal and/or corporate assets to the surety and/or questionable personal and corporate credit history. The collateral pledged to the surety company is a reimbursement guarantee to the surety if a loss occurs.

The terms and conditions for the pledging of collateral on a bond obligation are set forth in the surety company collateral security agreement. The dollar value of the cash collateral required by the surety can be based on a percentage of the bond penalty or the full value of the bonds. Collateral is typically held by the surety for the complete duration of time for which the bond is in effect or during which the obligee could make a claim on the bond.

44 What determines my bonding capacity?

Bonding, like bank credit, is mainly dependent on strong financials and adequate liquidity for a contractor to undertake the backlog of construction projects. Contractors need to have sufficient cash flow in terms of cash and working capital to be able to upfront the costs for insurance, bonding, labor, materials, and overhead for 60 to 90 days until they receive the first payment certification from the owner. Multiple projects require organization, cash flow, and plenty of managerial experience.

Under similar circumstances, bonding capacity will always favor those contractors that have superb financial information, which can be provided to surety companies on a transparent and timely basis, showing organization, commitment, and security that problems arising during the normal and customary business environment will be identified and dealt with immediately. Other important factors include a successful track record for the same types of projects, experienced personnel and subcontractors,

on-time accounts receivable collection (that is, no collection problems), and sufficient bank lines of credit to assist in case of a temporary situation where the contractor may not collect certifications on time.

Although bonding is as much an art as a science, the better organized a contractor is in terms of project construction and administration matters, the higher the chances are that bonding capacity will match or exceed the contractor's expectations.

45 How can I increase my bonding capacity?

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.

46 Do extended warranties cost extra or affect the availability of bonds?

Yes, extended warranties do cost extra; and, yes, they can affect a contractor's ability to obtain bonds, depending on the surety company performing the underwriting. For smaller, less financially sound contractors, this can pose a significant problem. The U.S. Small Business Administration can help such a contractor obtain bonding, depending on the length of the warranty. Generally, the length of the warranty must be three years or less.

47 How do I make a claim on a payment bond and what can I expect?

A payment bond obligates the principal, whether a contractor or subcontractor, to pay for labor and material furnished for use in the performance of the bonded contract. If the bond principal does not properly pay, then certain subcontractors and suppliers have claims under the payment bond. Those subcontractors and suppliers who are proper bond claimants are determined by statute or by the terms of the bond itself.

It is critical that claimants strictly observe the notice and time requirements under the terms of the bond or any statutes governing the bond. Most bonds require that a claimant that does not have a contract with the principal give the principal or the surety, or both, written notice of its claim within a relatively short period of time after the claimant furnished the labor or material for which claim is made. The time period may run from the date of the last of the claimant's work or from the date of each delivery. Courts will strictly enforce notice requirements, and a contractor will lose its payment bond rights if it does not comply with the notice requirements.

The best way for a claimant to facilitate the surety's evaluation of a claim is to write the surety, explain the claim, submit full and complete documentation supporting the amount owed, and ask for any forms or affidavits the surety needs to evaluate the claim. The surety will typically acknowledge receipt of the claim and ask for any missing information. The surety will also contact the principal and ask for its position.

The vast majority of payment bond claims are resolved amicably and promptly. When a principal has defaulted in its payment obligations, the surety should be expected to promptly pay those claimants that have established the validity of the debt and have met the notice requirements of the bond.

48 Are there any programs to help small contractors get started with bonding?

The surety industry is committed to helping small and emerging contractors obtain their first bond and increase their bondability. Many surety companies have developed programs especially for these contractors.

Furthermore, the federal government and some state and local governments have developed bonding support programs for small and emerging contractors. Surety companies, the National Association of Surety Bond Producers, the Surety and Fidelity Association of America, and local surety associations around the country have assisted with several programs that provide technical assistance, surety bonding, and working capital loan assistance services to small and emerging contractors.

For more than 40 years, the U.S. Small Business Administration's (SBA) Surety Bond Guarantee (SBG) program has helped small and emerging contractors who have the knowledge and skills necessary for success but lack experience and financial strength to obtain bonds through regular commercial channels. The SBA guarantees bid, performance, and payment bonds issued by participating surety companies to small and emerging contractors and reimburses the surety a percentage of loss if the contractor defaults. This government guarantee allows sureties to write bonds for contractors who otherwise would not meet their minimum standards, providing small and emerging contractors with access to a regulated surety market and with contracting opportunities for which they would not otherwise qualify. Contractors who qualify to use the SBG program do not automatically qualify for the SBA's limit of $6.5 million for a single contract.

The SBA Office of Surety Guarantees (OSG) administers the SBG program as a partnership between the federal government and the surety industry. The SBG program consists of the Prior Approval Program (Plan A) and the Preferred Surety Bond (PSB or Plan B) Program.

Contractors should contact a surety bond producer who represents a surety company that participates in the SBG program. A list of local-area producers, application instructions, and other program information are on SBA's website at www.sba.gov/osg or can be obtained by calling SBA's Office of Surety Guarantees at 202.205.6540.

49 Is my handshake good enough or should I have a written contract?

No, handshakes are not good enough for either party to a contract, no matter how small. A clean and unambiguous written contract is essential to a successful agreement, even between the most ethical parties, because it sets forth in plain terms (hopefully) the expectations of the parties. In brief, a contract states who is responsible for what obligations and the rights of each party, which permits sureties and lenders to understand fully the scope of the contract to be bonded.

There are many elements to a construction contact, but some of the important basics are as follows:

1. Full name, address, and signature of both parties. These are necessary in order for the contract to be enforceable in court.
2 Scope of work. This element is included in most construction contracts but often with too little detail, which causes disputes over out-of-scope work and change orders.
3. Project cost and payment terms. The cost for services included and the cost of services beyond the scope of the contract should be clearly stated. The schedule of payments, the amount due, and the terms and conditions of payment should be clearly set forth.
4. Schedule of work. Stated clearly in the contract should be the notice-to-proceed date, construction start date, and the date of completion. It should also provide which party, if any, is responsible for various kinds of delays (such as obtaining required permits and easements, bad weather, etc.).
5. Authority. It is critical that the contract makes clear who has the authority to make legally binding decisions during the construction project.
6. Dispute resolution. If a dispute does arise on the project, the contract should set forth the dispute resolution process (for instance, mediation and/or arbitration and/or litigation) to which the parties are bound.

There are a number of standard form contracts that are published by various construction industry stakeholders: America Institute of Architects, ConsensusDocs, Design-Build Institute of America, and Engineers Joint Contracts Document Committee. These standard form contracts are usually modified by the parties before signing. There are also customized or manuscripted contracts, which reflect project-specific information. Any contract should be thoroughly reviewed and analyzed by a knowledgeable construction attorney and negotiated, if necessary, before signing. Most construction contracts have similar language for certain key clauses, but even the change of a few words can significantly change a contractor's risk profile.

50 Why do I need a knowledgeable attorney in construction and surety matters if I do not have any current legal disputes?

A knowledgeable construction and surety attorney is a valuable legal and business advisor for any contractor, small or large, whether or not that contractor has current legal disputes. A knowledgeable construction/surety attorney knows about construction contracts, construction financing, construction management, dispute avoidance, dispute resolution (mediation, arbitration, and litigation), surety bonds and insurance, construction defects, liens, government permits and inspections, agency relationships, labor and employment law, business organizations, and corporate law, among other things.

Such an attorney can draft, review, and negotiate contracts and assess the risks that arise from the terms and conditions in the construction contracts and assist the contractor in avoiding and managing disputes and problems. One very important role for the attorney is to help the contractor understand what its rights, obligations, and duties are in all contracts. The role of the attorney is to provide advice and counsel to the contractor, negotiate good contracts, seek solutions to client problems, and guide clients through their business matters and disputes as successfully and cost effectively as possible.

51 How do I know that a bond is valid and that the bond has been authorized by the surety?

There are, unfortunately, unscrupulous persons in the marketplace who prey on contractors by issuing fraudulent surety bonds. Therefore, it is critical that you confirm that the surety is licensed in the jurisdiction of the project and that the bond has been authorized by that surety. A contractor can perform this task by undertaking the two-step process set forth below:

1. Check the authority of the surety to issue the surety bond:
   - ✔ Contact the state insurance department to determine if the surety is admitted in the jurisdiction of the project. Generally, sureties must have a certificate of authority from the insurance commissioner in each state in which they conduct business. The National Association of Insurance Commissioners provides a map with links to all state insurance departments, at **www/naic.org/state_web_map.htm.** Some states list admitted sureties on the insurance department website, but a quick call to the department will ensure the most current and complete information.
   - ✔ Consult the U.S. Department of the Treasury Listing of Approved Sureties, Department Circular 570. To provide surety bonds on federal construction contracts, a corporate surety must possess a certificate of authority from the U.S. Treasury Department. A listing of certified surety companies approved to provide bonds on federal contracts, known as Circular 570 (or the T-List), is posted by the Financial Management Service, Surety Bond Branch of the Department of Treasury, at **https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570.htm**
2. Verify that the surety actually authorized the issuance of the surety bond:
   - ✔ Contact the surety directly to receive verification that the surety bond has been duly authorized. All sureties listed in Circular 570 identify a specific contact phone number. In addition, the Surety & Fidelity Association of America administers a program in which surety companies (SFAA) voluntarily agree to receive inquiries for the purpose of verifying the authenticity of surety bonds, in the SFAA Bond Obligee Guide, at **www.surety.org/**

Your bond producer is a knowledgeable source of information about sureties and should be consulted for review of bonds, but nothing should replace your own exercise of due diligence regarding the authenticity of surety bonds.

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SuretyLearn

For more information and resources, visit www.suretylearn.org