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LET’S THRIVE TOGETHER

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Bonding Capacity

PRESENTED BY:
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Presenter Profile

KATHLEEN BALDWIN, CFA, CCIFP
Member

Profile

Kathleen has more than 15 years of experience in public accounting. She is a leader within the Firm's Construction Practice Group, which focuses on the delivery of accounting, auditing, tax and consulting services to the Firm's construction industry clients.

Ask Me About

- How to improve your company's bonding capacity
- The specifics of an indirect cost rate audit needed for DOT contracts
- Ways to protect your small business from fraud

TODAY’S TOPICS INCLUDE:

- What is “bonding capacity” and how can it be a benefit or detriment to getting work?
- What characteristics do sureties look for in contractors when establishing a bonding program?
- What factors should you consider when trying to maximize your bonding capacity?
- How can you plan your balance sheet to improve or increase your bonding capacity?

WHY ARE JOBS BONDED?

Owners' Risk Management Tool

- No matter how well planned and well managed a project may be, there is always an element of risk.
- Surety bonds provide a level of assurance that a project will be completed, even in the face of unforeseen circumstances.

ROLE OF SURETY

- Provides assurance to the project owner that the contractor is capable and qualified to do the job.
- If a contractor defaults, the surety provider arranges for completion of the project.

The surety provider performs an exhaustive review of the contractor when establishing a bonding program for a contractor.

TERMINOLOGY/BASIC POINTS

- Surety bond – an agreement between three parties: surety company, contractor, and project owner.
- Surety bond is NOT insurance; more like an extension of credit. (ex: performance bond)
- Types of contract surety bonds: bid bond, performance bond, labor and material bond

TERMINOLOGY/BASIC POINTS

- Bonding Capacity – the maximum total contract value a bonding company will extend to a contractor in performance bonds. Sum of all contracts being bonded.

- Bond premium – typically between one half of one percent and two percent of the contract amount; intended to cover underwriting process, not losses. Losses are recovered by claims on assets.

(2% premium on $1million contract = $20,000)

QUALITIES NECESSARY FOR BONDING

The Three C's:

- Character
- Capacity
- Capital

QUALITIES NECESSARY FOR BONDING – THE 3 C'S

Character

- Reputation
- Job performance history
- Suppliers and subcontractors payment history
- Banking relationships

QUALITIES NECESSARY FOR BONDING – THE 3 C'S

Capacity

- Experience
- Track record
- Equipment
- Personnel

QUALITIES NECESSARY FOR BONDING – THE 3 C'S

Capital

- Financial situation
- Bill paying ability to complete the project
- Various ratios and tests

WHAT IS SURETY LOOKING AT WHEN ESTABLISHING A BONDING PROGRAM?

1. Financial Information
2. Company information
3. Banking and insurance information
4. Job information

WHAT IS SURETY LOOKING AT WHEN ESTABLISHING A BONDING PROGRAM?

Financial Information

- Annual financial statements by qualified CPA (types, frequency, and content)
- Tax returns
- Schedule of equipment
- Personal financial statements of owner(s)

  (reconciled to company statements)

WHAT IS SURETY LOOKING AT WHEN ESTABLISHING A BONDING PROGRAM?

Company information

- Org chart (employees and responsibilities)
- Resumes of principal and key employees
- Description of cost accounting system (accounting software); how job costing is done
- Management policies & controls for monitoring job performance
- Business plan (firm specialties, markets, etc.)
- Business continuation plan
- References

WHAT IS SURETY LOOKING AT WHEN ESTABLISHING A BONDING PROGRAM?

Banking and insurance information

- Bank letter, showing history of relationship and balances
- Evidence of line of credit
- Certificate of liability insurance

WHAT IS SURETY LOOKING AT WHEN ESTABLISHING A BONDING PROGRAM?

Job information

- Contract
- Bid results
- Subcontracts
- Job history

HOW IS BONDING CAPACITY DETERMINED?

Factors considered:

- History of performing good quality and profitable work
- Strong, timely, & accurate financial reporting and controls
- Remain profitable over a number of years
- Maintain an acceptable level of capital within the business

HOW IS BONDING CAPACITY DETERMINED?

- Varies by Surety!!

General Rule: 10 x Working Capital (Net Quick)

WC = Current assets (Cash + AR 90 days or less) + Costs and estimated earnings in excess of billings) – All Current Liabilities (next slide)

WC $100,000 = $1,000,000 bonding capacity

See next slides for key points on WC calculation!!

Bonding Capacity

STANDARD CALCULATION

Assets			Liabilities	
Cash	$ 45,000		Accounts payable	$ 200,000
Investments	50,000		Accrued expenses	75,000
Account receivable	275,000		Capital lease, current	50,000
Inventory/Materials	275,000		Notes payable, current	165,000
Prepaid exp./Deposits	15,000		Total current liabilities	$ 490,000
Employee loans	5,000			
Deferred tax assets	30,000		Working Capital	$ 230,000
Stockholder rec.	25,000			
Total current assets	$ 720,000			

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HOW IS BONDING CAPACITY DETERMINED?

Key Points on the calculation:

- Definition of working capital may vary by surety (inventory, aging of ar, etc.)
- Single job limits are likely to be much lower than the X 10 factor (closer to 2 x WC)
- WC x Factor – the factor will vary depending on relationship with surety and the Three C's.

FINANCIAL ANALYSIS CONSIDERATIONS

Discounted items in Working Capital Calculation

- Intangible assets (goodwill, license, software)
- Inventory (usually 30-40% discounted)
- Doubtful receivables
- >90 days receivables
- Prepaid expenses
- Significant under-billings

ELIMINATED/REDUCED WC CALCULATION

Assets		Liabilities	
Cash	$ 45,000	Accounts payable	$ 200,000
Investments	50,000	Accrued expenses	75,000
Account receivable	275,000	Capital lease, current	50,000
Inventory/Materials	275,000	Notes payable, current	165,000
Prepaid exp./Deposits	15,000	Total current liabilities	$ 490,000
Employee loans	5,000		
Deferred tax assets	30,000	Working Capital	$ 230,000
Stockholder rec.	25,000	WC less red	$ 155,000
Total current assets	$ 720,000	WC less red/reduced blue	($30,000)
Inv 10k, AR >90 100k, excess inv. 75k			

FINANCIAL ANALYSIS CONSIDERATIONS

- Debt to Equity Ratio (Total Liabilities / Equity)
  - Should be less than 1; lower the ratio the better. Lower ratio means company is using less leverage and has a stronger equity position)
- How is debt structured (current vs long term)
- Consider selling equipment and leasing if not used regularly
- Minimize overbillings

BONDING CAPACITY - FINANCIAL ANALYSIS CONSIDERATIONS

Profitability

- Historical track record
- Estimated profit vs actual profit (Gain/Fade Analysis) (see next slide)
- Control overhead costs

PLAN YOUR BALANCE SHEET

- Improve working capital
  - Collect aged receivables
  - Monitor overbillings (billings in excess)
  - Prepaids (change timing of renewals)
- Convert line of credit to long term
- Leave equity in the company
- PPE – do you need to own? lease as needed?

MAXIMIZE CAPACITY

- Sufficient unused line of credit
- Continuity Plan
- Meet w/bonding agent/surety (next slide)
- Discuss year end distributions (no surprises)
- Limit loans to owners or affiliated groups
- Focus on core business & geographic region
- Collect old receivables
- Improve working capital
- Leave equity in the company

SURETY RELATIONSHIP IS CRITICAL TO YOUR BONDING PROGRAM

- Know the surety company – what size companies does it underwrite (large/small); what ratios and figures are considered important.
- Communicate – regular meetings; no surprises late in the game, bad jobs are expected
- Integrity – unjustified bonuses, questionable loans, powerboats on company accounts; surety wants complete confidence in contractor’s integrity.

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BENEFITS OF A SOLID BONDING PROGRAM

- Allows you to bid on public/large private jobs
- Lets owners & GCs know that you have been pre-screened
- Demonstrates to outside parties that the surety has qualified your financial strength and ability to complete jobs satisfactorily
- Allows you to focus on bid vs spending time trying to obtain a bond.

OBJECTIVES IN REVIEW

- What is “bonding capacity” and how can it be a benefit or detriment to getting work?
- What characteristics do sureties look for in contractors when establishing a bonding program?
- What factors should you consider when trying to maximize your bonding capacity?
- How can you plan your balance sheet to improve or increase your bonding capacity?

QUESTIONS?

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