Boosting Your Bonding Capacity: Key Financial Accounting Strategies for Construction Contractors

BY MATTHEW SAUCIER, CPA

The construction industry relies on surety bonds to ensure projects are properly financed, and the contractors carry out their duties. To obtain a bond, the general contractor must be underwritten and apply for the bond from a surety or insurance company. The application process is similar to a loan application from a bank. The amount of credit a general contractor can receive from a surety is referred to as "bonding capacity." A contractor's main financial reporting objective is to maximize their bonding capacity. To do so, contractors need to produce accurate and timely financial accounting statements, including balance sheets, income statements, and work-in-progress schedules.

Tangible Net Worth

A contractor's balance sheet is used to calculate tangible net worth. Sureties will typically omit or discount assets not considered liquid to arrive at a tangible net worth. These may include accounts receivable older than 90 days, under billings, prepaid expenses, intangible assets, and receivables from officers and employees. On the other hand, some long-term assets are treated as current assets, such as the cash surrender value of a life insurance policy. Other assets are reduced by a percentage to estimate their net liquid value, for example, marketable securities and inventory. The above adjustments to the total asset balance could cause a contractor's tangible net worth to be lower than expected. Tangible net worth is calculated as retained earnings, and capital stock, minus the above disallowed assets and liabilities. With retained earnings being a significant component of tangible net worth, a contractor should be cognizant of any distributions taken during the year. If large distributions are taken, it is best to inform your surety ahead of time and provide a reason. A contractor cannot maximize bonding capacity if it is overleveraged and has a poor debt-to-equity ratio. When it comes to the balance sheet and your bonding capacity, focus on liquid assets and maintaining reasonable debt and distribution balances in relation to retained earnings.

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Income Statement

Another focus area is the income statement. Here a surety looks at the period's total revenues, gross profit, and net profit. The surety compares income statements year over year to look for growth and efficiency. For efficiency, two key ratios are gross margin and net margin. Gross margin is the contractor's gross profit as a percentage of revenue. Gross profit is calculated by taking construction revenues and subtracting the costs of construction. Net margin is the contractor's net profit as a percentage of revenues. Net profit is calculated by taking construction revenues and subtracting costs of construction and selling, general, and administrative expenses. Sureties are concerned if a contractor has a large unexpected operating loss or consistent losses year over year. Contractors should be ready to discuss margin fluctuations over a period of 3-5 years and be able to provide steps to improve performance, if necessary. If the annual statement is poor with inconsistent job performance, a surety will want to see quarterly statements to track performance and verify improvement.

Work in Progress Schedule

The work in progress ("WIP") schedule is also crucial to bonding capacity. This schedule shows all jobs currently in progress and financial information for each job. A surety assesses project types, geographic locations, average gross margins, job costs, and cash flow needs. A WIP schedule must include the job name or number, total contract amount, total estimated cost, estimated gross profit, costs incurred to date, billings to date, and the calculation of over or under billings. Much of this information is best tracked using specialized construction accounting software.

For contracts spanning multiple periods, revenues, costs, and margins must be shown for the total period and with current and prior periods displayed separately. Over and under billings for each job are also displayed on the WIP schedule. Overbillings are when a contractor has billed more than the revenue earned on a contract. This amount is listed as a current liability on the balance sheet. Overbillings help a contractor manage cash flows by increasing cash and building profits within jobs. A healthy overbilling balance should coincide with a large cash balance. Total overbillings greater than the cash balance indicate that the contractor has billed for all the profit on the job prior to it being earned. This can lead to poor cash flow to finish the project. Underbillings are the opposite; a contractor has billed less than the revenue earned and is classified as a current asset on the balance sheet. Sureties tend not to like underbillings as a large underbilling could indicate using one job to help finance another. However, sometimes a job being underbilled is unavoidable, especially later in the project. A good rule of thumb is that one job should never have an underbilling greater than 10% of the total contract value.

Work in Progress vs. Completed Work

Sureties compare the gross margins for jobs on the WIP schedule to gross margins on the Completed Contract Schedule. This will allow a surety to gauge the accuracy of a contractor's estimates while a job is in progress

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compared to how they finish. If the gross margins are similar across both in progress and completed jobs, a surety can have confidence in the contractor's ability to estimate job costs, which increases confidence in the financial statements as a whole. Internally, contractors should aim for margin consistency over 3-5 year periods and be ready to discuss significant changes in profit margin with the surety.

Red Flags

Given all the above financial factors, sureties believe a strong relationship with a CPA is one of the best ways to maximize bonding capacity. Sureties prefer timely (within 90-120 days) and accurately prepared financial statements from CPAs with experience in the construction industry. Red flags from a surety point of view include: late issuance of financial statements, omission of important footnotes, and miscalculated WIP items such as over and under billings. Those items may cause a surety to lack confidence in the financial reporting of the contractor and ultimately lead to a decreased bonding capacity. A trusted CPA will facilitate a contractor to provide timely financial information in a preferable format, assist with tax planning, maximize cash flow, and improve the internal accounting processes to ensure the maximum bonding capacity.

About the Author

Matthew Saucier has over six years of public accounting experience and joined Rivero, Gordimer & Company in 2020. Mr. Saucier has considerable experience working with not-for-profit and commercial organizations. His commercial experience includes construction, manufacturing, franchising companies, and health care. His experience in not-for-profit organizations includes independent schools, civic associations, and homeowners' associations. Contact Mr. Saucier at 813-875-7774.

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