

THE BOTTOM LINE



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Coverage

Corp.



EXCELLENCE IN SURETY BONDS

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Planning To Take The Next Step

Part of a contractor's growth process is to consider project sizes larger than any other jobs completed to date. Contractors looking to grow their companies address this situation quite frequently. While such decisions regarding contract size and your particular appetite for growth may seem just part of the day to day business routine, how you approach these projects and the success you have on them can determine what type of Contractor you become.

There are many things to consider when considering the "next level" in project size. More often than not contractors are capable of performing the physical work for larger projects. The challenge comes more on the administrative and financing side. Case studies regarding Surety losses indicate that contractors are more apt to fail attempting their largest project to date, not from direct performance issues but from the paper side of the business or insufficient cash flow. To be successful at the next level, your administrative capabilities must match your contracting abilities.

The inability to meet cash flow and the processing of timely and accurate paperwork are two of the major reasons why contractors face problems on larger projects. A cash flow analysis should be performed prior to bidding on that "next level" project. If cash flow is tight or there is a history of slow collectibles on projects you are currently involved in, it would not be a good time to attempt this project. Start up and mobilization costs are higher and you would need to carry more costs for a longer period of time. You should make sure that you have sufficient cash flow to move forward. Review your bank line of credit to see if it is sufficient to support the anticipated cash needs on the project. Your line should also be sufficient for your total backlog needs. If the majority of your bank credit is already being used, prior to looking at a larger project, consider applying for an increase in your bank line. Keep in mind that a bank line is best used to support spikes in labor or pay material costs. The line should not be relied upon to support the cash flow needs of your pro-

jects (day-to-day business). Bond companies consider such situations a red flag.

Always err on the side of conservatism when preparing and analyzing these reports. Be realistic; do not kid yourself into thinking that things are better than they really are. We have heard some contractors that subcontract a majority of their work say that they do not need any money to finance a project. We have seen that this is not the case. Mobilization, deposits to vendors, assisting subcontractors, covering overhead expenses, etc. need to all be considered.

The paper process is also very important. Larger projects require more time in the office working on submittals, organizing labor, etc. Your staff should be capable of addressing the paperwork properly and in a timely fashion. When an owner is delayed in receiving paperwork the payment process will most likely be delayed. If the paperwork is incorrect, then not only are there delays in payment, but the owner will lose confidence in the capabilities of the contractor. Perception plays a large part in how the relationship between owner and contractor plays out. Placing your company in a positive light by providing timely paperwork goes a long way towards the Owner's confidence in your firm.

There are plenty of other items to keep in mind when looking at the next level project as well. Larger projects bring on greater visibility (Union vs. Non Union and prevailing wage issues) project coordination, experience of Project Managers, etc. You will need to place yourself in a position to be prepared to successfully handle these matters as well. Larger projects simply have different environments than smaller contracts; it is not just simply more square footage.

Have confidence! You already know you could do the physical work on larger projects. A little business planning and forethought will go a long way in allowing you to take on any project successfully. It is a documented fact that businesses (including the contracting business) with a written business plan have a much greater chance of succeeding than those that do not have a plan.

"Famous Quotes"

"Anyone who dares to waste one hour of life has not discovered the value of life."

Charles Darwin

"In the middle of difficulty lies opportunity."

Albert Einstein

"The secret of success is to be ready when your opportunity comes."

Benjamin Disraeli

"A democratic government is the only one in which those who vote for a tax can escape the obligation to pay for it."

Alexis De Tocqueville

"Death is the most convenient time to tax rich people."

David Lloyd George

"The Rich aren't like us—they pay less taxes."

Peter De Vries

The Impact of the New Private Sector Prompt Payment Law

"A tax loophole is something that benefits the other guy. If it benefits you, it is tax reform."

Russell B. Long

"Taxes, after all, are the dues that we pay for the privileges of membership in an organized society."

Franklin Delano Roosevelt

"To be successful in business, be daring, be first, be different."

William Marchant

"Grasp the opportunity to manage change, not avoid it."

Anonymous

"Don't let the fear of striking out hold you back."

Babe Ruth

"Get good counsel before you begin; and when you have decided, act promptly."

Sallust

"The greatest discovery is that a human being can alter his life by altering his attitudes of mind."

William James

"It is not by whining that one carries out the job of a leader."

Napoleon

On July 18, 2002, Governor George Pataki signed a private sector "prompt pay" law for the construction industry. The law requires prompt payment by owners, contractors and subcontractors for construction work on private projects over \$250,000 in New York, and spells out steps in the payment process that owners, contractors and subcontractors must follow. The new law will go into effect on January 14, 2003.

This new law doesn't apply to:

- 1) Contracts on projects where a permit has been issued and work has begun before July 18, 2002.
- 2) Contracts on projects for any NYS or local government agency or public department
- 3) Contracts on projects relating to or required by the September 11, 2001 terrorist attacks on the World Trade Center.

The owner and GC must follow the following payment procedures unless the contract says otherwise:

1) Billing Cycle Must Be Set

- The owner and GC can set their own billing cycle, however, if none is set, then the billing cycle will be the calendar month.

2) Approving / Disapproving Invoices

- Once a contractor submits an invoice with all of the accompanying documents required by the contract, the owner must approve or disapprove payment within 12 business days. The owner cannot unreasonably withhold its approval or in bad faith disapprove an invoice or a portion of an invoice. "Bad Faith" will be open for interpretation.
- If an owner doesn't approve an invoice, it must give the contractor a written statement describing the items in the invoice that it didn't approve. There are only six reasons an owner can disapprove an invoice:

1. Unsatisfactory or disputed job progress
2. Defective work
3. Disputed work
4. Contractor's failure to comply with material contract requirements
5. Contractor's failure to make timely payments

6. If the architect fails to certify payment for any of the above reasons.

3) Paying Invoice

- Payment from the owner to the contractor is due within 30 days after the owner approves the contractor's invoice. However, if the owner is using loan proceeds to finance the project, then the owner must pay contractors within seven days of receiving payment from the lender.

4) Amount of Payment Owners Can Withhold

- The owner must give the contractor a detailed description of the item it's withholding money for in its payment. For example, if a contractor issues a payment request in the amount of \$100,000, and the owner is upset with the caulking on the project, the owner can only withhold the line item amount set aside for the caulking. All other work must be paid-in-full.

5) Contractors' Remedies for Nonpayment

A) Interest

- If the owner pays after the payment's due date, the owner must pay the contractor interest beginning on the next day at a rate of 1% per month on the unpaid balance.

B) Suspension of Work

- If an owner doesn't pay the contractor by the payment's due date, the contractor can suspend work on the project without violating the contract. Even if the contract bars suspension of work, the contractor can still suspend work for nonpayment. However, before a contractor can do this, the contractor must give the owner 10 days written notice saying that it hasn't received payment for an undisputed invoice amount and that it intends to suspend performance if it doesn't get paid by the 10th day. If work is suspended, the completion date is automatically extended for the length of time performance was suspended.

If you are a subcontractor, there are additional rules that we will discuss in our next issue. If you would like a copy of the new law, please contact us at (516) 682-5000. As always, we recommend you contact your attorney to discuss this matter in further detail.

Revision of New York's Mechanic's Lien Law

As reported in the Sept/Oct 2002 issue of the Subcontractor's Trade Association "Subcontractors News", effective January 1, 2003, the procedure to bond off a lien has been changed in New York. Before we go into the new law, let's take a step back and review the following items:

- 1) What is a mechanic's lien?
- 2) How did we bond off the lien prior to the new law?

When the owner of real property and a contractor enter into a fixed-price contract, the contract price is the monetary limit for what the owner of the property is obligated to pay. However, the owner's obligations to suppliers of labor and materials who are not paid by the contractor, are not limited to the prime contractor's contract price.

Most states have what are known as mechanic's lien laws, which give unpaid suppliers of labor and materials a statutory right to file liens against the owners' real estate for the value of their labor or materials. The procedure for filing a mechanic's lien varies from state to state. NYS mechanic's lien statutes require notice within a specific time limit to perfect a valid lien. Affidavits are also required to meet statutory requirements. When a lien is filed, the owner of the property is notified and must withhold future payments to the contractor, until either the con-

tractor settles its obligation to the supplier or discharges the lien by filing a bond.

In the past, contractors who wanted to bond off the lien, had to make an application to the Court for an order fixing the amount of the bond to discharge the lien. Under the new law, contractors and owners simply need to get a bond for 110% of the lien amount. On a private sector project the bond also needs to be conditioned on the payment of any judgment against the property for the enforcement of the lien.

On public project the contractor needs to file the bond with the State or public entity for which the lien was filed and serve it to the party who filed the lien.

The law also states that the surety must be authorized to transact business in New York. As long as the New York Superintendent of Insurance has issued a "certificate of qualification" under New York's Insurance Law and there's a statement that the certificate hasn't been revoked, no further "justification" of the bond is required. A more complicated process is needed if the surety isn't authorized to do business in New York.

This is a brief overview of the revised mechanic's lien law. For more information, please contact an attorney that specializes in construction law, or you can call us at (516) 682-5000 for a copy of the new law.

"Our plans miscarry because they have no aim. When you don't know what harbor you're aiming for, no wind is the right wind."
Seneca

"Only two things are infinite: the universe and human stupidity. I'm not sure about the former."
Albert Einstein

"The surest sign that intelligent life exists elsewhere in the universe is that it has never tried to contact us."
Calvin and Hobbes, by Bill Watterson

"Leadership is a potent combination of strategy and character. But, if you must be without one, be without strategy."
Norman Schwarzkopf

"The secret of business is to know something that nobody else knows."
Aristotle Onassis

"It is impossible for a man to learn what he thinks he already knows."
Epictetus

Company News

On Sunday October 21, 2002, the staff of ACC walked in the Annual Breast Cancer Walk at Jones Beach. This was a five-mile walk to help fight the spread of breast cancer. The staff of ACC and their families were proud to raise money for this important fight. Thanks to all those who supported us in this endeavor.

Congratulations to Anthony and Maria Spina on the birth of their daughter Samantha Lynn on September 14th.

Letter from the Editorial Staff

This newsletter is designed with our readers in mind. All inquires and ideas regarding this or future newsletters are appreciated. Please send all inquires to me at anthony@esuretybond.com. If you know anyone who you feel would like a copy of our newsletter, please let us know so that we can include them in our mailing list. Please let us know if you would like to receive this newsletter via e-mail.

Disclosure

The Bottom Line is published quarterly by Atlantic Coverage Corp., 6800 Jericho Tpke., Suite 212E, Syosset, NY 11791. Telephone (516) 682-5000. A service for our clients, contacts and friends, it is meant to provide useful business information and practical advice and encourage its readers to keep up with all the latest developments. These articles are not intended to provide a complete discussion of the subjects presented. Because each situation is unique, we advise you to contact us before acting upon any of the following information or planning ideas contained in this newsletter. Any questions you might have about any topics mentioned in this newsletter, please contact our office.

Underbillings and Surety Credit

Underbillings are the item on your Balance Sheet known as "Costs and Estimated Earning in Excess of Billings". Conceptually, you know what they are, but how does a bonding company view this item? Usually, with skepticism. Technically, they are considered a Current Asset on your Balance Sheet. As such, this item SHOULD help your bonding program. You know by now that it is not that simple. Let's review the basic calculation by reviewing this sample job:

Contract Price	Est. G.P.	GPM %	Billed to Date	Total Est. Costs	Costs to Date	Cost to Complete	Percent Complete	Revenue Earned	GP Earned	Underbillings
\$10,000,000	\$2,000,000	20.00%	\$7,000,000	\$8,000,000	\$6,300,000	\$1,700,000	78.75%	\$7,875,000	\$1,575,000	\$875,000

The Underbilling is calculated by adding the Costs to Date (\$6,300,000) and the Gross Profit Earned to Date (\$1,575,000) and subtracting the Billed to Date (\$7,000,000). The Gross Profit Earned to Date is the Total Estimated Gross Profit multiplied by the Percent Completed.

The Balance Sheet will reflect the \$875,000 Underbilling as a Current Asset. If the CPA is considering it an asset, why then would the bonding company treat it differently? Accounting for a construction firm depends largely on estimates — estimates of gross profit and estimates of costs-to-complete. Surety underwriters are taught to view things from a worst-case scenario. Let's look at the same project to show how the underbilling asset disappears if the gross profit number is revised downward. Keep in mind, that only that number has changed. This then changes a lot of other numbers.

Contract Price	Est. G.P.	GPM %	Billed to Date	Total Est. Costs	Costs to Date	Cost to Complete	Percent Complete	Revenue Earned	GP Earned	Underbillings
\$10,000,000	\$2,000,000	20.00%	\$7,000,000	\$8,000,000	\$6,300,000	\$1,700,000	78.75%	\$7,875,000	\$1,575,000	\$875,000
\$10,000,000	\$1,000,000	10.00%	\$7,000,000	\$9,000,000	\$6,300,000	\$2,700,000	70.00%	\$7,000,000	\$700,000	0

See what happens? That Asset disappears when the Gross Profit estimate is revised downward.

You cannot eliminate Underbillings in construction, so how do you convince your bonding company that they are a real asset? Start by realizing what caused the Underbilling. Was it an unapproved change order? If it was approved subsequent to the financial statement (F/S) date, show that to your bonding company.

Here is, also, where your track record becomes important. Remember the three to five years of financial statements you provided when you began the relationship. If a firm historically realized a Gross Profit Margin in the 9% to 12% range, then they will likely discount a portion of the Underbilling if you are claiming that you are making a 20% Gross Profit Margin.

Bonding companies, also, consider how far into a job a contractor is when determining which underbillings are of concern to them. A project that has just started or is 20% complete or less may typically be underbilled and usually is of much less concern to an underwriter than a project that is more than 50% complete and still underbilled.

While tax deferral strategies are important, keep in mind that bonding companies always treat Accounts Receivable more **favorably** than Underbillings.

If your firm recognizes revenue for tax purposes on the Accrual or accrual-less-retainage method, make sure that you document to your bonding company when the requisitions went out and when the money was subsequently collected.

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