

WHY DO CONTRACTORS FAIL?

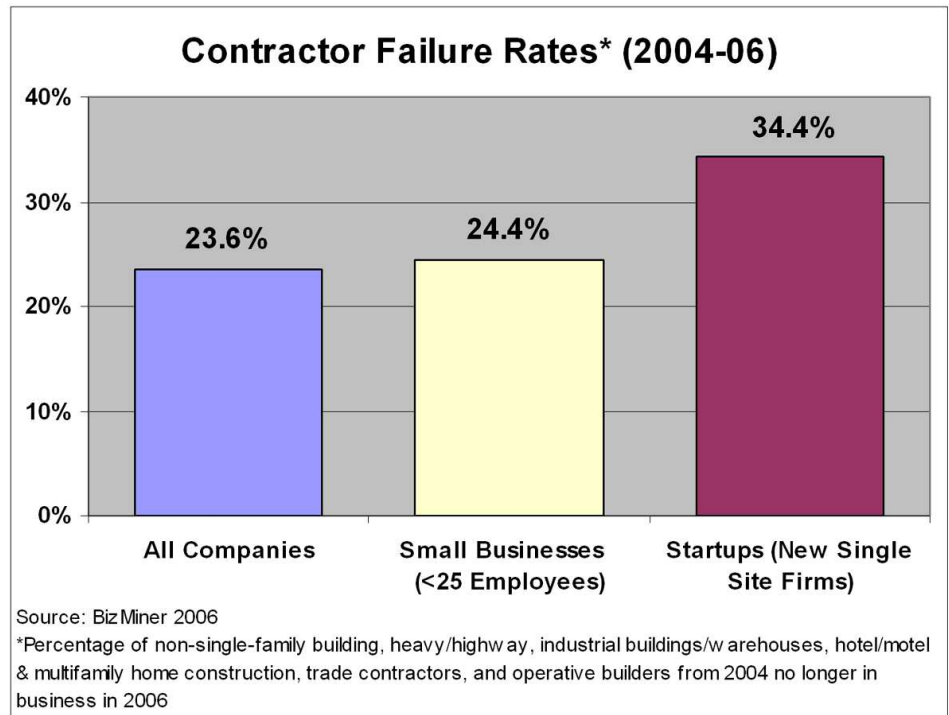
Surety Bonds Provide Prevention & Protection

Construction is a complicated business that faces ever-changing conditions, and those who are not prepared or capable of meeting these demands may ultimately fail. According to BizMiner, of the 850,029 building (non-single-family), heavy/highway, industrial buildings/warehouses, hotel/motel and multifamily home construction, and specialty trade contractors operating in 2004, only 649,602 were still in business in 2006—a 23.6% failure rate. Every year thousands of contractors, whether in

business for two years or 20, face bankruptcy and business failure. These firms leave behind unfinished private and public construction projects—and still worse, billions of dollars in losses to project owners and taxpayers. Public and private construction project owners can mitigate the risk of contractor failure by requiring bid, performance, and payment bonds.

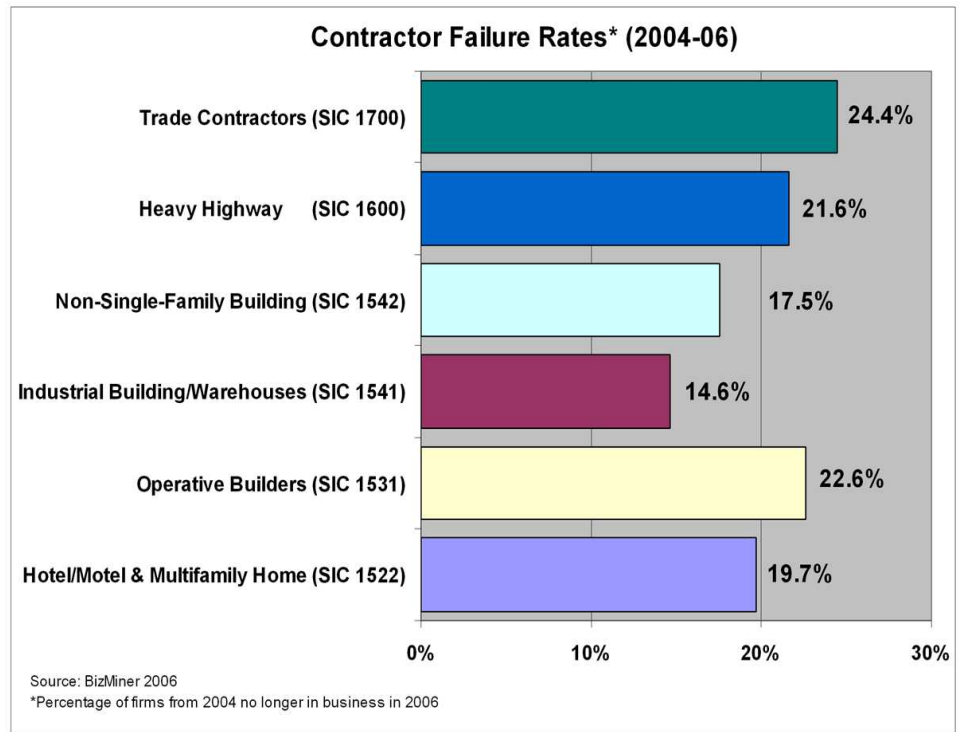
Surety bonds provide financial security and construction assurance to project owners by verifying that contractors are capable of performing the work and will pay certain subcontractors, laborers, and material suppliers. This is especially important on public projects where taxpayers' dollars are at risk.

Surety companies are well positioned to analyze and manage construction risks because of their close relationships with contractors and surety bond producers. The surety bond producer works with contractors to prepare the necessary documentation for the rigorous prequalification process conducted by the surety company. Through the prequalification process, the surety verifies the contractor's ability to perform the contract and fulfill its financial obligations (taking into account the contractor's current and projected commitments).



Prequalification is an in-depth process, which includes a complete review of financial statements, capacity to perform, organizational structure, management, trade references, credit history, and banking relationships. Before a surety company will issue a surety bond, it must be satisfied that the contractor runs a well-managed, profitable enterprise, deals fairly, and performs obligations as agreed.

Because preventing contractor default is a key component to the surety business, surety companies and surety bond producers are experts at spotting business practices and conditions that can lead to contractor failure.



Events That Lead to Contractor Failure

Contractor failure is usually the result of multiple causes. The Surety & Fidelity Association of America (SFAA) reviewed 86 claims cases and identified the top five factors related to contractor failure:

Factors Contributing To Contractor Failure	Cases That Include The Indicator
Unrealistic Growth	37%
Performance issues	36%
Character/Personal Issues	29%
Accounting Issues	29%
Management Issues	29%

Unrealistic Growth

- Change in type of work performed
- Expansion into a new geographic area
- Significant increase in the size of individual projects
- Rapid or over-expansion

Performance Issues

- Inexperience with new scope or types of work
- Personnel do not have adequate training or experience
- Insufficient personnel

Character Issues

- Contractor retires, dies, sells company, changing leadership or focus
- No ownership or management transition plan to ensure continuity in the event of death or disability

Accounting Issues

- Inadequate cost and project management systems
- Estimating or procurement problems
- Lack of adequate insurance
- Improper accounting practices (not adhering to the *AICPA Audit Guide for Construction Contractors*)

Management Issues

- Key staff leaves company
- Staff inadequately trained on company policy and operations
- Insufficient or incapable personnel at upper management or project level
- Failure to maintain solid accounting and management systems to track costs and billing

Other Factors

- Economic down-turn and high inflation
- Weather delays
- Poor site conditions and/or building plans
- Labor difficulties (lack of skilled labor)
- Material and equipment shortages
- Owner's inability to pay
- Onerous contract terms

Warning Signs That a Contractor is in Trouble

Ineffective Financial Management System

- Inability to forecast cash flow or cash flow is tight
- Receivables are turning over too slowly
- Vendors are demanding cash on delivery for supplies and materials
- Bills are past due
- Profit fade

Bank Lines of Credit Constantly Borrowed to their Limits

- All credit fully secured
- Credit lines not being renewed

Poor Estimating and/or Job Cost Reporting

- Revenue and margins decrease over time
- Continued operating losses
- Loss or reduction of bonding capacity
- Bidding jobs too low

Poor Project Management

- Inadequate supervision
- Inability to administer and collect change orders
- Project(s) not completed on time
- One or more contracts have a claim
- Company is constantly involved in litigation
- Increase in backlog without adequate project management resources
- Lead time to prepare bids too short

No Comprehensive Business Plan

- Contingency plans are not developed
- Company does not have a “road map,” goals, or objectives

Communication Problems

- Disputes between contractor and owner
- Poor communication from field to management

Qualities of a Solid Contractor

According to FMI Corporation’s “What Makes a Good Contractor?” by Stuart M. Deibel, good contractors share these characteristics:

Organization

- Formal and on-the-job training for all levels of employees
- Logical, incentive-based compensation plan
- Tenure for proven field superintendents and internal promotion when possible
- Depth at all levels of the organization
- Succession planning
- Up-to-date, distributed organization chart
- Culture of loyalty, ownership, and urgency
- Visionary, inspirational leadership
- Low turnover

Finance

- Solid management of cash flow and overhead
- Profit-focused company
- Timely payment of bills
- Management of debt and retainage
- Reasonable growth without overextending resources

Marketing

- Superior estimating skills and systems to manage costs
- Satisfied customers
- Well-defined market niche and 12-36 month growth plan
- Company culture where everyone is a great salesperson

Project Control

- Closely managed projects with early warning systems to catch potential problems
- Litigation avoidance
- Productive field managers trained to improve processes

Planning

- Disaster preparedness
- Continuity plan with:
 - adequate life insurance coverage;
 - share-holders' agreements detailing buy-sell agreement for multiple shareholders;
 - only qualified and interested family members in management;
 - detailed business plan; and
 - strengths, weaknesses, opportunities, and threats.

It's a variety of successes that makes a good contractor, and it's a process that happens continually. Good contractors will heed the warning signs of failure before the red flags go up.