SHEA SURETY

INSURANCE SERVICES

Surety 101

The following is an overview of surety underwriting, including some tips to contractors for ways to improve their company's bonding capacity:

Information needed by most surety companies:

I. Financial Statements:
- **a) last three fiscal year end statements, reviewed by a reputable CPA, with full footnote disclosures and supplementary schedules of work-in-progress and completed contracts.**
- **b) most recent available interim financial statements, in-house ok.**
- **c) accounts receivable aging reports for most recent FYE and any interim statements provided.**
- **d) work-in-progress schedules for all interim statements.**

What the surety underwriter does with this information:

Three years of statements are requested so the underwriter can look for trends, and also review old job schedules to see if profit fade is an issue. The underwriter will analyze the statements to determine key ratios, like net quick assets, (NQA), and note how these have changed over the three year period. The underwriter will also check the quality of the prepared statements by the CPA, and note if the CPA is a firm that is familiar to the underwriter. In a properly prepared financial statement, the job schedules can be reconciled to the gross profit shown on the income statement for the year. The calculations of the NQA and other key ratios are the underwriter's way of determining the <u>Capital</u> of the contractor.

The interim statement is obtained to see how the company is doing in the fiscal year currently in progress. This statement is also analyzed, but full credit for improvements to the last fiscal year end statements is not usually given, just as a loss shown on an interim statement may not have a negative effect. Many contractors do a lot of work in the summer, and if the interim statements only cover the late fall and winter, for instance, a loss for that period is likely normal, and will hopefully be offset once the spring and summer months are added to the picture.

Accounts receivable agings are used to determine if the receivables shown on the balance sheet should all be counted as current assets when determining key ratios, like NQA. For many surety companies, anything shown as over 90 days old is excluded from current assets, in some cases, even if that receivable has been collected subsequent to the balance sheet date of the statement in question. This can have a severely negative impact on a company's bonding capacity. These agings are required with all financial statements, and should reconcile to the balance sheet total for accounts receivable.

Work-in-progress schedules are reviewed by the underwriter to see how jobs that have been previously reported are faring, and to determine current backlog. Profit fade is examined, and if it is prevalent, it can hamper bonding capacity. Another red flag is underbillings on jobs in progress. These can indicate unapproved change orders being recognized, or possibly gross profit being overstated. Though underbillings are shown as a current asset, a contractor would be wise to limit them and try instead to

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show his jobs as slightly overbilled if possible. Overbillings may indicate that profit is being understated, so the underwriter may assume there is a bit of "profit insurance" built into the interim statement.

The financial statements are almost always the key to any underwriting decision. I mentioned the Net Quick Assets figure (NQA) as a ratio upon which the sureties place a lot of reliance. NQA is current assets minus current liabilities, aka: working capital, less prepaid expenses, receivables from related entities, accounts receivable shown as over 90 days old, and any other current assets that are not readily convertible to cash. Cash surrender value of life insurance owned by the company is shown as a long-term asset, but it can be included in NQA, because it is liquid. The amount of bonding capacity a surety will allow at any one time is often a multiple of NQA. Typically, a general contractor's bonding capacity will be a multiple as much as 20 times NQA. A subcontractor, which has tougher cash-flow constraints because they pay a lot more labor costs and often prepay for materials to get cash discounts, normally will find their surety support in the 10 times NQA range. These ratios apply to the aggregate component of bonding capacity.

Bonding capacity has two components, single job, which is determined largely based upon the previous experience of the contractor; and, aggregate, which is the amount of uncompleted backlog, including non-bonded work, that a surety will allow at any one time. The backlog is based upon the total cost to complete the jobs-in-progress.

The second most important ratio the financial statements will reveal is the Cash/Note position, which is total cash on hand, per the balance sheet, compared to the balance owing on the company's bank line of credit, established for working capital shortfall needs. Companies that show too much reliance on bank debt will find their surety capacity curtailed until they can reestablish positive cash-flow and lower their debt. When the bank debt gets too large, the company's very existence is in the hands of its banker, and if they lose that support, meeting payroll may become impossible, and surety claims will likely follow soon thereafter.

There are other ratios that the sureties sometimes mention, like debt-to-worth, but the NQA and Cash/Note are really the most important. I have at least two clients with working capital that is more than 10% of work-on-hand, have over seven figures in cash, and no current bank line usage. These clients are what some underwriters refer to as "pig-iron underwater", which is an old fire insurance description of a very, very safe risk. Needless to say, bonding capacity is not an issue for these clients.

II. Personal Financial Statements from all indemnitors. These can be prepared by the indemnitors using a bank form, or something similar to the form we have attached in our "Forms Section".

The underwriter gets these financial statements annually, and they are used to see if the owner has any additional liquidity available, should it be needed, and also to determine the worth of the supporting indemnity. Generally, you must own in excess of 10% of the company before a surety will require you to provide personal indemnity. In cases of very large, experienced companies….usually with working capital and net worth in excess of $10 million, and more than 10 years in business, the surety may consider waiving personal indemnity entirely. It is a worthy goal for any contractor to strive for the waiver of personal indemnity.

III. Contractor's Questionnaire. These are forms provided by the surety or the surety broker, with the purpose of aiding the contractor in gathering and organizing their background information. This includes references like the following: banker, CPA, attorney, insurance broker, as well as their creditors, (subcontractors and suppliers), and customers, (list of five largest jobs with contact information). The form also lists the company's owners, including their ownership percentage, Social Security Numbers and home addresses, as well as the names and titles of the company's officers. A copy of such a form is included in our "Forms Section".

The underwriter uses this information to run credit reports and do reference checks with the people listed. A contractor that lists professionals that are well-known in the construction industry, is going to gain some level of esteem from the underwriter. If the reference checks go well, it can make a difference in getting a larger level of bonding support. However, the credit reports that get run by the surety, and many run several different such reports, are used by the underwriter to help determine that the contractor has good character, as shown by prompt bill payment and a lack of liens and lawsuits filed. A poor credit report can be the sole reason a good contractor is rejected for bonding, so it is a good idea for contractors to try to keep track of their credit reports, and quickly correct anything that is being misreported.

The underwriter will want to meet the contractor, which will also figure largely into the <u>Character</u> evaluation.

The list of large jobs is very important in the underwriting process. These lists should include job description, contract amount, gross profit earned, date performed, and the name and contact number for the owner/construction manager that can verify that the job was done well, and that the contractor would be favorably considered for future work. This, along with job schedules shown in the financial statements, is primarily how underwriters determine the <u>Capacity</u> of the contractor.

IV. Copy of bank line of credit agreement currently in effect.

The underwriter reviews this agreement to determine that the contractor has not broken any covenants. In most cases, the underwriter will ask to speak with the banker to get a good idea of the nature of the relationship. A good banking relationship is more important if cash-flow is tight for the contractor. Sureties like to see that another creditor has found this contractor to be a good risk. It is therefore important for all contractors, even those with little need for a line of credit, to establish a solid relationship with a banker, preferably one who is well-known in the construction industry.

Summary:

To maximize your bonding potential, build your company's net worth and cash. Make cash/flow a mantra. Surround yourself with professionals that know your industry…..please see our "Links" section. Most importantly, hire a surety broker of Irish ancestry, preferably with a CPA designation and a degree in business from Cal. Go Bears!

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