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FEATURE

Increasing Bonding Capacity and Maximizing Surety Credit

Financial strength and tracking project success will help contractors improve their bonding qualification.

BOND PRODUCERS AND construction-oriented certified public accountants (CPAs) know well that their contractor clients often ask how they can increase their bonding capacity. Those contractors want to increase their bonding capacity in order to bid on larger projects, grow their businesses, and maximize their profits. Contractors are only as reputable and profitable as their last project. One bad job can affect the opinion of a surety and, ultimately, impact the contractor's bonding program. Labor and material shortages, equipment issues, weather delays, and other problems challenge contractors and make the construction industry one of the riskiest. How can construction contractors manage this risk and take steps to maximize their bonding capacity?

Proper Planning to Maximize Surety Credit

In order to maximize surety credit, a contractor must show it is a secure financial risk; and proper planning is critical. Prior to the close of the contractor's year-end, the company and its CPA should meet to work out a plan for the following year. Planning should include reviewing interim financial information, including ratios and metrics relevant to the contractor's bonding program, tax planning, and modeling out the results for the end of the year. The plan should also include any recommendations from the CPA that would

help strengthen the contractor’s financial statement. Finally, it should cover budgeting for future project bids and identify the bonding requirement needed to facilitate each bid

Reducing the Impact of Surety Working Capital Adjustments

Bonding capacity is the maximum amount of surety credit a surety company will provide to a contractor. There is the single limit, which is the maximum amount of a single bond for any project; and there is the aggregate limit, which is the maximum total amount of bonds a contractor can obtain. There is no "one size fits all" formula; the calculation is contractor-specific, based on risks determined through review of a contractor’s reputation, experience, and organization. A contractor’s bond limit is largely determined by working capital and net worth as reflected in the fiscal year-end financial statements. In general, surety credit is based on the lesser of 10 to 20 times adjusted working capital or 10 to 20 times net worth.

Different surety companies have different appetites for risk, and sureties may adjust various factors in the working capital calculation. Below is a general example of how a surety might determine working capital for surety credit:

CURRENT ASSETS	
Current Assets – GAAP Basis	$ X,XXX
Subtract:	
• Contracts receivable over 90 days old	(XXX)
• Receivables from officers, employees, owners	(XXX)
• 50 percent of inventory not at a job site	(XXX)
• Prepaid expenses	(XXX)
Add:	
Cash surrender value of life insurance	XXX
Current Assets – Surety Credit Purposes	X,XXX
Current Liabilities	
Current Liabilities – GAAP Basis	(X,XXX)
Adjusted Working Capital for Surety Credit	**$ XXX**

Sureties and bond producers reduce surety credit by the over-90-day bucket of the contractor's contracts receivable. To minimize this adjustment, contractors can implement two steps. First, they can make sure balances included in the over-90-day bucket do not include retainage; if the balances do include retainage, this item should be reclassified and presented as retainage receivable. Second, contractors should include cash collections made on the year-end contracts receivable balance as either a disclosure or supplemental schedule. Any cash collections made on balances included in the over-90-day bucket will reduce the surety's working capital adjustment.

Contractors should analyze the inventory balance included in the financial statements. They should ask if the inventory represents uninstalled materials (contract asset vs. inventory), which would reduce the inventory adjustment. They should consider what the cost is of reclaimed inventory, which would

also offset the inventory adjustment. In addition, contractors should ask whether the inventory actually represents prepaid contract costs or supplies on hand. Presentation differences could reduce the surety's adjustment.

Contractors should work with insurance agents to change insurance renewal periods. One month after year-end would help to reduce prepaid expenses and preserve cash at year-end, eliminating the prepaid adjustment.

If possible, loans to shareholders and employees should be paid down by the end of the year. The stockholder can also loan the contractor cash prior to year-end and subordinate it to the surety company. Subsequent to year-end, the contractor should disclose any repayment of this loan to reduce any surety adjustment.

Contractors should have net cash balances and avoid borrowing and carrying long-term debt, to the extent possible. There are additional steps that contractors can also take to manage the presentation of current liabilities on their financial statements. Contractors should maintain an "evergreen" line of credit, which is paid down on a monthly or quarterly basis. The availability of this line of credit can be added to available working capital. In addition, they should extend the maturity date of the line of credit to long-term status and, if possible, any clean-up provisions to present any outstanding line of credit balances as long-term on the balance sheet. In addition, contractors should refinance existing debt and line of credit to reduce the current portion. Refinancing can be recorded even if subsequent to year-end. Finally, contractors should use long-term debt borrowings for equipment purchases rather than paying for these purchases with cash. Equipment is a long-term asset on the balance sheet, which does not add to the working capital calculation. Therefore, to the extent possible, contractors should match the payment for these long-term assets with long-term liabilities.

Eliminate Any "Surprises"

While it is important to understand what impresses sureties, it is just as important to understand what alarms them, when attempting to maximize bonding capacity. Red flags go up for sureties when they see patterns of profit fades, underbillings, and unapproved change orders.

Analyzing contract estimates for project gains or fades will provide the surety with confidence that the contractor can properly estimate a job. Patterns of gross profit fades, or decreases in the estimated gross profits year-over-year measured on a project-by-project basis, could significantly increase the contractor’s reputation and experience qualifications with the surety, having a direct impact on the bonding capacity and program. Timely meetings with project management teams internally, and owner and key management oversight on the contract estimates, are key. Additionally, identifying any issues ahead of time, with timely identification of the contractor’s professional team (bond producer, attorney, CPA, surety), along with an action plan, is key if a contract estimate is in a fade position.

Contractors having multiple contracts in an underbilling position, or consistently presenting significant underbilling on the financial statements, raises significant questions for the surety. Underbillings could indicate poor billing practices, which calls into question the contractor’s ability to grow and adequately manage cash flows. Underbillings could also indicate future contract losses. Contractors should identify billing issues ahead of time and work with the project teams to readily identify opportunities to overbill. Contractors should make it a priority to timely bill on a monthly basis.

Having a significant amount of unapproved change orders indicates the contractor’s inability to timely submit these change orders for approval and illustrates a weakness in a contractor’s internal control procedures. Having consistent changes in contract estimates requiring explanations to the surety company, including unapproved change orders, will create red flags. The more time that passes before a contractor submits a change order for approval, the less likely the change order will get approved.

Understanding and Benchmarking Key Ratios

In addition to the two major metrics—working capital and net worth—sureties often use additional ratios in evaluating a contractor's financial health and also benchmark contractors against competitors. Understanding these ratios will give the contractor a key insight and better prepare it for any questions that may arise during the surety review and analysis. Below are examples of key ratios and benchmarks used by sureties for healthy construction contractors.

KEY RATIOS AND BENCHMARKS

Cash greater than 5% of annual revenue (non-borrowed)	Contractors should maintain an available bank line of credit of at least 5% of annual revenues. In addition, cash as reported on the contractor's annual financial statements must exceed overbillings, with any differences maintained or tracked through accounts receivable.
Tangible equity greater than 15% of annual revenue	Stated equity as reported on a contractor's financial statements is adjusted to remove goodwill, related-party receivables, prepaid expenses, and off-balance sheet tax liabilities, including subsequent distributions to the owners for taxes and deferred tax liabilities, which represents tangible equity.
Tangible working capital of at least 10% of annual revenues (5% minimum)	Stated working capital as reported on the contractor's financial statements is adjusted to remove prepaid expenses, underbillings, current pass-through tax distributions, non-turning inventories, and old receivables (over 90-days outstanding), which represents tangible working capital. Tangible working capital also excludes a "13-month" line of credit that is secured by short-term assets, which is a planning tool often used by contractors to manage working capital presentation.
Low debt ratios	Low debt ratios include maintaining an interest-bearing debt to tangible equity of less than 50%. This is a baseline that varies within certain trades of a contractor; for example, heavy highway or equipment-intensive contractors usually carry a higher interest-bearing debt ratio around 80%. Additionally, total liabilities to equity ratios are recommended to be less than a 3 to 1 ratio.
No significant underbillings (costs in excess of earnings)	Underbillings is the highest indication of risk on a contractor's balance sheet. Underbillings usually indicates poor billing practices and often represents a loss or fade that is realized in subsequent periods. Contracts should analyze correlation between underbilled jobs and subsequent profit fades.
Overbillings (billings in excess of costs) should exceed 2% of annual revenue or uncompleted backlog revenue (if less)	Best-in-class healthy contractors know their costs and how to properly estimate a job, including how much of the total estimated costs represent strict budgets for each trade, general conditions, potential cost savings, and contingencies. These contractors usually have a higher gross margin recognized on completed contracts than estimated gross margins on uncompleted contracts, under-promising and over-delivering on contract estimates. A contractor should analyze 5-year gross profit trends by type and geography, to identify trends that may require additional focus and review.
Profit fade or gain less than 10% of original gross profit percentage	Best-of-class healthy contractors know their costs and how to properly estimate a job, including how much of the total estimated costs represent strict budgets for each trade, general conditions, potential cost savings, and contingencies. These contractors usually have a higher gross margin recognized on completed contracts than estimated gross margins on uncompleted contracts, under-promising and over-delivering on contract estimates. A contractor should analyze 5-year gross profit trend by type and geography, to identify trends that may require additional focus and review.
Use of profit estimates less than historical profit until job is 50% complete	Some contractors take conservative approaches, using zero profit estimates for new jobs until 10% complete, a common planning tool to manage tax and GAAP financial statement reporting. Increased profits over historical profit estimates based on completed contracts is rare in the construction industry. A contractor should maintain a contract schedule sorted by type of work, customer, location, and project manager, as each could impact the estimated gross profit estimates.
Good cash flow	Contractors manage cash flow on projects by front-end loading cash (permanent job borrow), which is a common practice of overbilling to the owner on contracts. In addition, managing the receivable collection period of less than 30 days (45 days max) and collection of retainage on completed projects within 90 days are other common practices that best-of-class healthy contractors use in maximizing cash flows.
Low fixed general and administrative costs	Depending on the industry or trade in which the contractor operates, G&A percentage of revenue should be 2% to 5%. Subcontractors usually have higher percentages than general contractors. It is important that contractors properly identify indirect contract costs and use full absorption job costing through burden rates to minimize general and administrative costs and properly estimate jobs.

Other Considerations

Contractors that provide timely, high quality, accurate information to sureties add credibility to their reputation for good internal controls. Sureties find such information, particularly in the following four areas, helpful during the underwriting process: (1) contract schedules; (2) historical profit analysis schedule; (3) contract cost budget (phase code) analysis; and (4) analytical reports.

Contract Schedules

Contractors should create several contract schedules. One such schedule should show what is completed and uncompleted by type of work, division, etc. Second, they should create a cost-to-cost method schedule (unless a more conservative method is used). This type of schedule will probably be mandated by GAAP in future pronouncements. Third, contractors should provide a quarterly analysis of cost-to-complete, showing timely communication and meetings with the project managers to accurately update contract estimated costs to complete, identifying change orders that need to be processed, and identifying any issues in a timely fashion. Fourth, they should develop a schedule showing segregated costs associated with unapproved change orders and claims. Any such recordings should show cost only with appropriate discounts. Fifth, contractors should create a schedule that reflects bonded and non-bonded subcontractor exposure. Finally, contractors should have a schedule describing what they have learned from jobs that sustained a loss that describes why they believe they lost money.

Historical Profit Analysis Schedule

Contractors should create historical profit analysis schedules. These include a schedule providing a 5-year contract gross profit history by type of work and a schedule showing profit recognized in excess of historical data. Contractors should avoid excess profit recognition until a contract is more than 50% complete, which is a key internal control procedure in a down market.

Contract Cost Budget (Phase Code) Analysis

Contractors should develop a cost budget analysis that compares actual to original bid budget, investigates significant variances, and compares material quantities bid to quantities purchased.

Analytical Reports

Contractors should create analytical reports that provide a bid spread analysis, labor ratios and benchmarks, equipment utilization, and fuel usage reports with comparison to units, mileage, hours, etc.

Contractors may consider joint ventures for several reasons, including entering into new markets, gaining experience in new types of construction that will broaden the contractor's ability and experience, and preserving bonding capacity by sharing resources and risk. By joining forces, contractors can win the job, save on costs, and share in the profits. As with any business transaction, it is important to know the party with whom the contractor is getting involved before that joint venture is formed. Construction joint ventures can vary in their legal forms; therefore, it is absolutely vital to consult an attorney.

Financial metrics and measurements are great on the surface. However, if a contractor does not have a strong accounting infrastructure in place, there will not be a timely review of the results and identification of issues, which will put the contractor in a very difficult position. Long-term planning requires maintenance of internal controls. Contractors rely on accounting systems to provide information about overhead, payroll, supplies, and equipment costs. These are crucial to preparing bids and knowing where the contractor stands on each contract as work begins and throughout the completion of each project.

Conclusion

Contractors seeking to increase their bonding capacity should take an honest and timely look at their financial position and decide on areas for improvement. A good CPA can help contractors plan for year-end, evaluate internal controls, identify areas of weakness, recommend areas to maximize credit, and work with the surety to explain the balance sheet to add further credibility.

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