

Obtaining, Maintaining & Effectively Using Surety Credit

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INTRODUCTION

Every contractor has a different way of developing the information necessary to make the day- to-day and long term decisions involved in running their company. Primary sources for that information come from both internal and external sources. The key elements within the operation are the experience and education of the construction firm's staff and internal controls which give both historical information along with current information necessary to monitor the uncompleted work program. There are four principal external sources:

1. Accounting from a CPA or accountant
2. Legal advice from an attorney
3. Credit advice from a banker
4. Counseling on surety credit from a surety agent.

The internal information received is quite familiar because the contractor uses it everyday. The input from outside the operation is much less familiar and can be quite complex and difficult to understand for someone who does not use that information daily.

The intent of this publication is to emphasize the importance of surety credit, how to obtain the maximum amount available, and once it is obtained, how to realize its full value. We will begin by briefly defining the surety industry and how it works. We will try to show what a surety expects from a contractor and in turn, what the contractor should expect from the surety. The result should be a better understanding of the desired partnership/interaction between the surety and the contractor.

THE SURETY INDUSTRY

A surety is a person or a corporate entity that makes itself responsible for another's obligations. When the concept of suretyship was first developed, the surety was normally a person and not a corporation as is usually the case today. However, when a default occurred, it was difficult for a court of law to rule against a person and take away his/her assets simply because he/she had guaranteed the obligations of another. (Often the assets of that individual were not sufficient to satisfy the claim anyway.) As time went by, the corporate surety industry developed because it was more efficient for large and financially sound companies to handle the surety business. Significant impetus occurred in the early 1900's when the federal government began requiring performance and payment bonds on all its projects. There are several hundred companies writing surety business but just a few write the large majority of the bonds. Today, surety is a highly specialized field which is dominated by a relatively few number of companies.

A surety bond is a three party contract. The obligee, (usually the owner) is the party guaranteed by the bond. The contractor is the principal on the bond and the surety, which in today's market is usually a large insurance company which acts as guarantor of the contractor principal.

The bond guarantees the obligee (owner) that if the principal (contractor) defaults, the surety will complete the contract on behalf of the principal. As long as the contractor performs all of its obligations to the owner, the surety will have no role. Should the contracting firm default on its obligations to the owner, then the surety stands in its place to see that those obligations are fulfilled. Should the surety have to perform on behalf of the contractor, it becomes entitled to the unpaid contract balances which normally would have been paid to the contractor by the owner.

Upon contract completion, the surety has the right to seek reimbursement or its non-reimbursed costs from the contractor.

Although suretyship is considered a line of insurance, it has many characteristics of credit. Unlike bank credit however, the surety does not actually loan money to the contractor but instead allows its financial resources to be used to back the commitment of the contractor to the owner. Another significant difference is that surety rates average generally less than one percent while bank lending rates are normally pegged at the current prime rate. Although a surety does charge premiums, surety bonds differ from other lines of insurance in that those premiums do not include a sum to pay for anticipated losses. In essence, surety premiums are a fee charged for the extension of credit, i.e. issuance of the performance and payment bonds.

WHAT DOES A SURETY EXPECT FROM A CONTRACTOR?

A surety needs a broad range of written documentation regarding the contractor's operations and performance, coupled with a personal visit with the contractor plus job site inspections. In addition, most sureties make inquiries of owners of the larger or more significant projects completed to see if they were satisfied with the work. Also, the contractor's major suppliers and subcontractors are usually contacted for their opinions of the contractors.

For clarity, we will put this in outline form in two sections: Documentation and Personal Contact.

(1.) DOCUMENTATION

A.) History

The surety wants to know when and how the company was formed (who started it, what they started it with, what they were doing previously before they started), ownership history of the company, any joint ventures undertaken and a summary of the current operations.

B.) Key People Resumes

This ties in tightly with the operations of the company. It is important to illustrate, in a clear format, the experience of the key people in the company both with prior construction companies and in the present company. This will give the surety a better understanding of the types and sizes of projects they have worked on and will enable the surety to feel comfortable (hopefully) about their handling similar projects in the future.

C.) Organizational Chart

A clear presentation of authority and responsibility should be shown delineating the key people running the company. This will indicate to the surety the depth of management continuity for the company.

D.) Work Record

This is a schedule of major projects completed over the past five years, indicating owner, architect, project superintendent (or foreman) who ran the job, contract price, original estimated gross profit, final gross profit on completion of the job, estimate completion date and actual completion date. This record is a key element in "selling" what projects you do best or in explaining what may have gone wrong with some projects and how you intend to correct those problems. The information should be presented in a manner that makes it easy for the surety to check with each of these owners and architects.

E.) Accountant

A surety will be able to tell rather quickly from your financial statements if your accountant is construction-orientated. It is important that a contractor have an accountant who is capable of advising him/her on the proper methods of accounting in the construction industry and who is capable of preparing acceptable financial statements. Some CPAs are more knowledgeable in construction than others and it is wise to seek out a CPA firm that is indeed recognized as a construction-orientated accounting firm.

F.) Financial Statements

The surety needs a minimum of three years and preferably five years of fiscal year-end financial statements to give them a "picture" of the operations of the company. These financial statements are more acceptable if they are audited and they should have all of the supporting schedules suggested by the AICPA standards for construction accounting. The statement should include a cover letter indicating the type of examination made by the CPA, a balance sheet, a profit and loss statement and the notes to the financial statement which explain major items in the balance sheet and the way the income is reported.

The supporting schedules that round out a financial statement are: 1.) contracts completed; 2.) contracts in progress and 3.) a breakdown of general and administrative expenses

Some other schedules may be necessary for certain contractors but these are the three basic ones required by most sureties.

G.) Interim Financial Statements

Interim financial statements may be helpful in obtaining surety credit if it has been more than 6-8 months since the contractor's fiscal year-end or if the fiscal year-end statement indicated adverse conditions that no longer exist. It should be recognized that a surety will not rely as much on an interim statement as on a year-end statement. This is primarily because interim statements normally do not include all of the expensed items and accruals that will appear in the year-end statement.

H.) Work-in-Progress

A schedule of the current contracts indicating contract name, contract price, original cost, cost to date, billings to date, cost to complete and estimated completion date are necessary to give the surety a understanding of the current financial position of the company. For continuing surety credit, the work-in-progress schedule can be the most important tool in determining the success of current operations between year-end financial statements.

In most cases, the reliability of this information is critical to obtaining surety credit and is definitely critical in obtaining any surety credit that is requested on a "stretch" bond request. For it to be reliable, the contractor should have excellent internal costing systems along with proper reporting from the field. Sureties have found that in any successful construction operation these two items exist. We all know they are essential to controlling a project and completing it, not only on time, but at a profit.

I.) Budgets

Proper planning by a contractor requires some form of budgeting system. Use of the work-in-progress schedule to indicate income expected during the next 12 months - evaluated against existing overhead items and operational expenses - can provide the contractor the ability to project profit levels for the year.

This allows the contractor to determine if the firm is making money or if it needs to reduce overhead or obtain additional work to make a profit. This also demonstrates management's planning ability to the surety. In addition, it gives the surety a better handle on what type of work program and what profit margins are necessary for this contractor to make a profit.

J.) Credit

The surety will want to be able to contact the major suppliers and subcontractors and make contacts with the banking facility utilized by the contractor. Sureties are concerned about how a contractor pays bills, what type of bank credit is available, the terms of that bank credit, and how the contractor has met his or her financial obligations in the past.

K.) Continuity

The majority of construction companies, unfortunately, do not have sufficient continuity plans. Many construction firms are closely-held corporations with one or two owners and a closely knit group of people who actually run the company. If a surety is to guarantee the long-term obligations of a contractor, some form of a continuity plan is necessary. A buy-sell agreement between the major stockholders or between a major holder of the company should be formulated and funded. This allows a smooth transition of the company should an unfortunate occurrence arise (such as death of an owner), minimizing the possibility that a loss would occur to the surety because of a default on any of the bonds written (due to estate problems of the owners of the company.)

L.) Personal Indemnity and Financial Statements

Since most companies are closely held corporations, most sureties will want to have the personal assurance of the major stockholders that they are going to put forth their best efforts in seeing that the obligations of the company are met. In some cases, personal assets can increase surety credit available to the corporation. For a proper evaluation of what loss paying power the personal indemnity does provide, the surety will request personal financial statements. Personal indemnity is not always required by surety companies but it does indicate that you have as much faith in your own operations as you are asking of the surety writing your bonds.

M.) Current Insurance Program

A summary of the contractor's current insurance program indicating both the coverage and the limits of liability should be relayed to the surety so that they can evaluate how well those insurable risks are being handled. Surety companies are in agreement that the construction industry is hazardous enough without also having a contractor improperly or inadequately insured.

N.) Objectives

All of the foregoing information tells the surety company where you are and how you got there. By informing the surety company of the objectives and goals of your company in a clear and concise manner, you can tell the surety where you want to go and how you plan to get there. The better you can convey to a surety company how you plan to use the talents and assets of your company to grow and obtain a certain level of success and stature in the industry, the more willing and able the surety underwriter is going to be to relate to your goals and provide the surety credit you are requesting.

(2.) PERSONAL CONTACT

A.) Contractor Meeting

If a picture is worth a thousand words then a visit to a contractor at the company's office, to meet the people who are involved in the operation of the company, is worth a million words. To get a better feel for the expertise of the people involved in the construction company, most surety underwriters will require that they first meet with the contractor before providing any surety credit.

Although contractors are asked to provide surety companies with a great deal of paper, it is still a people-orientated business. In addition to meeting with the people who run the company, the surety underwriter should be taken out to some completed projects and have the project thoroughly explained by describing what the contractor actually did on the project. Also take the underwriter to see current projects underway and have the project engineer or supervisor walk him or her through and explain exactly what work is being done on those projects.

This type of on-site inspection of work performed gives a surety underwriter (regardless of experience in the construction industry) a truer feel for the operations of the contractor and therefore better enables him/her to communicate effectively with his/her superiors in obtaining the requested surety credit.

WHAT SHOULD THE CONTRACTOR EXPECT FROM THE SURETY?

One of the most important things a contractor should expect from a surety is competent, knowledgeable, timely and consistent responses from the underwriting department. A surety company's value to a contractor is directly dependent upon the ability of the local underwriter to effectively communicate the attributes and abilities of the contractor to his/her superiors, whether they be in the same city, or elsewhere. You can have some of the most knowledgeable people in the surety home office but if the underwriter is not knowledgeable, or does not have their confidence, then it may be difficult to obtain the necessary surety credit from that company simply due to ineffective communications.

A contractor should also expect the surety company to communicate openly. If the surety does not fully understand why a contractor wants to do a certain project, they should communicate that and explain why they feel it is either too ambitious or too risky. Quite often a knowledgeable surety company may have additional input into a project of which a contractor has not been aware. In other words, they can advise you of certain risks that they have experienced in other parts of the country or with other contractors on similar projects. However, the only way you are going to become aware about this is if you have open and candid communications with the surety.

A surety has the opportunity to give you objective input regarding planned major changes in operations, personnel and geographic territory. It can provide you with information about the construction industry throughout the nation and in some cases, internationally. It can provide a broad base of experience upon which to draw additional input for strategic business decisions.

It can give you an objective and dispassionate evaluation of your operations, your costing system, budgets and objectives. A surety's evaluation is usually made on a more conservative and less optimistic basis than a contractor's.

A surety can also be of assistance in the evaluation of prospective subcontractors both locally or out-of-town. They are also effective in confirming financing on private jobs which the contractor may be considering.

THE PARTNERSHIP AND ITS INTERACTIONS

As in any business partnership, effective communications is necessary to make the relationship grow and prosper. The growth and development of the partnership between the contractor and surety is no different. We have tried to outline what the surety expects from the contractor and what a contractor should expect from the surety. The only way either of these can be accomplished is with open communications between the two parties.

One of the best ways to assure this is to have a professional surety agent involved to first develop information and then negotiate between you and the surety company. The agent, also called a producer, has gained experience by dealing with several surety companies and a number of contractors. The producer has a feel for the current condition of the surety market and the attitudes of particular companies toward particular kinds of contractors. Surety underwriters and agents establish long-term relationships which usually result in a large measure of trust and confidence thereby helping to ensure that thorough consideration is given to each request. The agent is also in a position to recognize unreasonable requests and explain why a contractor sometimes should not request a surety to consider bonding a particular project.

Most surety companies truly recognize the value of a competent agent and thus operate under the American Agency System. They cooperate with their agents in each community to provide prompt and efficient service to contractors. Your professional surety agent wants to help you obtain the surety credit you need. The agent prospers only when you do and can serve you best if you communicate openly and frequently.

This publication was written by members of the National Association of Surety Bond Producers in support of members of The National Utility Contractors Association.