WHY ARE FINANCIALS SO IMPORTANT TO YOUR SURETY?

BY CHRIS MURPHY

The mission of surety underwriting is to determine whether a contractor has the financial resources to pay its bills today and to forecast if the contractor could continue paying them if faced with adversity in the future.

Many factors determine the long-term success of a construction company: thoughtful and experienced leadership, skilled people in the field and in the office, a sound business plan, luck and more. But financial analysis tends to get the most attention when it comes to surety underwriting.

Most underwriters agree that a contractor's strengths and weaknesses are reflected in the company's financial statements in some way. Most underwriters also believe that without a face-to-face meeting, they can't really get to know a contractor.

The business community generally understands financial terms and measurements. What most contractors want to know is: "What do these financial measurements mean to surety underwriters, and what business strategies can ensure our company is in the most favorable position in these terms?"

In the final analysis, there are no absolutes. Each company needs to be managed according to its own circumstances. For example, an underwriter often views a contractor's balance sheet with minimal interest-bearing debt quite favorably. Not having to service debt in a future that may or may not be sufficiently profitable clearly lowers risk and improves financial flexibility. So one might conclude that borrowing money is a bad idea if impressing the underwriter is the goal. But, a business manager who avoids all risk also may avoid the possibility of meaningful returns.

Contractors should have trusted advisers (a professional surety bond producer, underwriter, CPA, etc.) who can provide feedback on their plans, but only hindsight will determine whether the plan was a good one.

FINANCIAL STATEMENT

The income (or profit and loss) statement is simply a report card of how much activity (revenue) was performed during the period, how profitable that activity was (gross profit/loss), and what it cost the contractor to run the business (overhead). The underwriter examines these carefully against industry and geographical norms. Importantly, the underwriter focuses on the trend of these measures over several years.

- For example, if the trend reveals 30 percent revenue growth every year, the immediate concern is the speed of that growth. While revenue growth in a technology company may make its stock price surge, in construction it creates questions about whether pricing was sacrificed to create revenue growth, whether the contractor has the people or systems resources to manage the growth without things falling through the cracks, and whether the contractor has the cash to finance larger receivables.
- If overhead seems higher than a contractor's peers, the underwriter will question whether the business is being run to maximize profitability and financial strength, or to finance expensive personal lifestyles. Clearly, some companies are mature and have built superior financial strength over time, and therefore minimize the need to retain significant profits going forward. But in general, overhead analysis can be the underwriter's window to the contractor's true priorities.

BALANCE SHEET

The balance sheet demonstrates what the contractor has (assets) and what the company owes against those assets (liabilities). The difference is the net worth of the business. Net worth is significant to the surety because it measures the long-term staying power of the business. But short-term staying power is important, too. Payroll, accounts payable and debt payments all need to be paid regularly—in cash.

- Underwriters analyze working capital to assess the contractor's ability to finance these requirements. Any interruption of cash coming in—a disputed receivable or change order, unprofitable projects, etc.—can place unbearable pressure on the contractor's ability to meet obligations. The underwriter analyzes the balance sheet in the context of "what if." Could the company survive, and for how long, if adversity strikes? Contractors that maintain their balance sheet to support only normal circumstances may not be enthusiastically supported by their surety. Rainy-day capitalization (or risk capital) can be critical to obtaining the desired level of surety support.

- Leverage is an important area of focus as well. Taking on debt may be the best thing for the contractor's business, but contractors should carefully question whether buying a piece of equipment or a building (and taking on debt to pay for it) is the best move at the time. Especially if the contractor's overall financial strength is modest, renting equipment or putting off other asset purchases until financial strength improves may be the best course of action. Also, overdependence on an operating line of credit to finance cash flow may indicate undercapitalization. These are areas where a contractor should solicit the counsel of trusted advisers.

STATUS OF PROJECTS

A surety also looks closely at the financial status and trends of individual projects via the work in progress (WIP) schedule. Analysis of the estimated cost to complete the backlog may indicate how heavily the contractor's resources are being utilized and measure the contractor's capacity. The estimated gross profit in the backlog gives an idea of future profitability, assuming the estimates hold up over time. The WIP also shows whether a project is underbilled or overbilled.

- An underbilling suggests the contractor is financing the project for the owner in some way. It also may be a sign that the contractor has prematurely counted the revenue of a change order to which the owner has yet to formally agree. Or, it may simply indicate the contractor has not revised cost estimates on the project. Rather than acknowledging that costs have exceeded budget, resulting in a lower gross profit, an underbilling occurs. Gross profit decreases on jobs are often disguised as underbillings, so substantial underbillings are subject to scrutiny by the underwriter.
- Also significant is the underwriter's ability to view WIPs over several periods and track the estimated gross profit on a job over time. Steady margins that hold up through completion are a sign the contractor likely produced a solid estimate before beginning construction and was able to execute in the field according to the estimate. This is an extremely favorable indicator of the contracting firm's overall quality. Contractors that conservatively report their estimated gross profit during construction, and then consistently report an increase on completion, are held in high esteem not just for their ability to execute, but also for their conservatism. On the flip side, WIP trends that show project gross profits regularly slipping from start to completion tell the underwriter there is a problem in estimating, in execution, or both.

Not all underwriters have the same perspective on the business or on financial analysis. Construction executives should discuss the financial analysis with a professional surety agent and an underwriter to ensure a meaningful relationship.

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