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# Financial Health in Today's Bonding Market

Understanding barriers & shaping a strategy to secure better premiums
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Economic health is a huge driver of the construction industry. More than halfway through 2022, the industry has experienced rising interest rates, continued price increases, extended material lead times and persistent shortages of skilled workers. The success of managing these challenges is captured on a final scorecard — a business's year-end financial statements.

While year-end financial statements represent past performance, they play an important role in shaping the future, especially for construction companies that require bonding. Although the past does not always provide insight into what the future may bring, historical financial statements demonstrate the quality and competency of a company and are relied upon highly by sureties.

With construction at an all-time high, many contractors have been selective about which projects they bid on and, as a result, have been able to develop a healthy backlog. While some might think this environment resulted in record years, final year-end scorecards often showed a different result in terms of profitability.

Even though some contractors ended 2021 with positive net income driven by the Paycheck Protection Program and Employee Retention Credits, others experienced losses. The financial disruptions to the industry relate to rising prices and extended lead times on materials, coupled with rising labor costs and skilled labor shortages. Many companies were unable to pass rising costs to customers, which contributed to the lower-than-anticipated profit. The financial disruptions were offset by the government incentive programs developed to help businesses keep their workforces employed. What will be the outcome as the industry moves forward without additional incentive programs while continuing to face increased prices for both materials and labor, extended lead times and a shortage of workers coupled with a slowing economy?

Like the 2008 housing crisis when banks relaxed their due diligence measures, contractors have benefited from a more flexible surety environment. For bonded contractors, the expectation should be more and higher levels of scrutiny from sureties. Due to increased market risk as well as the market hardening, sureties have begun strengthening their due diligence processes before approving bonds. While additional conversations and information may be required to obtain bonds moving forward, there are steps businesses can take to ensure they do their part to increase trust and keep bond premiums as low as possible.

When underwriting bonds, sureties focus on the most recent reviewed or audited year-end financial statements, as well as current internal financial statements. Utilizing a reputable certified public accounting (CPA) firm with construction-specific expertise instantly increases the confidence level during the underwriting process. A set of financial statements from a quality CPA firm reduces questions and concerns and can impact the availability of better bonding programs. Quality financial statements allow sureties and underwriters to focus their efforts on the completed contracts and work-in-process (WIP) schedules, job specifics and benchmarks including working capital, net worth, backlog and project gains and fades.

As mentioned above, companies are generally asked to provide internal financial statements in conjunction with CPA-reviewed or audited year-end financial statements. Sureties place importance on how closely internal financial statements compare to year-end financial statements, along with the gains or fades on jobs year over year. The closer internal financial statements match reviewed or audited financial statements, the more confidence and reliance sureties can place on internal financials as well as the overall management of the company and its operations.

To achieve more consistent financial results, consider the following best practices:

- Conduct a monthly review and update of the estimated costs on contracts to ensure the expected gross profit/loss is being utilized — this ensures a timely recording of job and non-job-related expenses.
- Record reoccurring entries, such as depreciation expense.

If performing these best practices monthly is not cost-effective, they should be done, at a minimum, before reporting financials to third parties such as sureties or bankers. When reviewing financial statements for bonding purposes, importance should be placed on cash management as well as specific ratios, such as working capital and net worth. Three factors that tend to cause cash-flow stress for companies are the seasonality of the business, customer nonpayment and the state of the economy. Cash flows tend to be irregular due to contract terms, often including a payment schedule based on completion of project phases, so it is imperative that companies frequently assess cash collections, billings and the profitability of projects. By understanding where the financial health of a business currently stands and the impact of internal and external factors, companies can better manage cash flows as well as key ratios that reduce the perceived risk of the sureties.

Generally, surety specialists evaluate three Cs when determining a contractor's risk level:

- *Capacity* — Does the contractor have the necessary technical skills, knowledge, equipment, experience and staffing to complete the project? This question can be answered by reviewing WIP reports as well as previous jobs completed by contractors. WIP schedules are examined for contract prices, billings to date, costs to date and estimated costs to complete, in order to determine job cost stability and profitability. Completed jobs provide the historical trend of overall profitability.
- *Capital* — Is the company financially viable? As there is financial risk associated with construction projects, it is imperative that a company demonstrates its ability to meet obligations, sustain adequate working capital and generate positive cash flows. The proof of financial stability is generally illustrated in reviewed or audited financial statements. Since financial statements play an important role in determining whether a surety bond will be issued, companies should work with reputable accounting firms that specialize in the construction industry and understand an underwriter's perspective.
- *Character* — What type of reputation does the contractor have within the construction industry? Character is determined by evaluating a contractor's history and relationships, reputation for taking unusual or unnecessary risks,

integrity, commitment to obligations, and past and pending litigation against the company.

Ultimately, the ability to secure bonding is dependent on risk. It is important to maximize the attractiveness of the company from an underwriter's perspective. Gaining a clearer understanding of how surety specialists evaluate a construction company will enable you to better understand how to assess risks and analyze the company's financial health to improve operations, which would result in the likelihood of securing bonds at a more favorable premium. With the possibility of impending recession and the economic environment being a driver of the construction industry, businesses would be wise to remember and focus on the three Cs.

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