Comprehending and Maximizing Surety Credit

BY ROBERT MERCADO AND MICHELLE JOHNSON

More often than not, contractors are required to obtain surety bonds in order to secure new work from both public and private owners. The bonds provide specific guarantees to the project owner, ensuring a contractor will perform based on the particulars of the contract.

If a contractor fails to perform based on the above bonding stipulations, the surety pays the damages outlined in the bond coverage. The surety will then pursue recovery of any damages paid from the guarantor(s) of the bonds—normally the company and its stockholders.

The Importance of the Third "C"

Surety credit is based on what is known as the "3 Cs", i.e., the character, capacity and capital of the contractor [*For more on this topic, visit page 44*].

In terms of financial liability and reporting purposes, working capital, or the third "C," is the difference between current assets and current liabilities of the contractor.

Stockholders' equity is the amount of capital the contractor has invested in the company, along with the earnings from inception of operations that have not been withdrawn from the company.

Surety-Adjusted Working Capital

Sureties will begin by calculating the working capital shown on the contractor's financial statements.

Normally, surety credit is a calculation based on the audited or reviewed year-end financial statements of the contractor, which is required to be performed by a certified public accountant.

Once working capital is determined, the surety enters adjustments in order to formulate the surety-adjusted working capital. Those adjustments include:

- Removal of any outstanding receivables more than 90 days past due, as of the date of the audited or reviewed financial statements.
- Removal of 50% to 100% of inventory held by the contractor.
- Removal of loans to any affiliated entities or stockholders.
- Removal of prepaid expenses included in working capital.
- Review of the credit worthiness of any notes receivable. If it is determined that there is a risk of collection, the surety may remove any notes receivable from the working capital.
- If there is any cash surrender value of life insurance shown as a long-term asset, the surety will include this amount as a current asset for its potential to obtain cash from the insurance policy.

Surety-Adjusted Stockholders' Equity

Adjustments are also made to the stockholders' equity based on loans to shareholders or related parties, including related entities. Stockholder loans to the company can be considered equity of the contractor if they are subordinated to the surety.

Maximizing Surety Credit

Gaining an understanding of which adjustments affect the surety-adjusted working capital and surety-adjusted stockholders' equity provides many opportunities to maximize surety credit potential. Because surety credit relies solely on the health of the year-end financial statements, the following will provide guidance related to items that can be addressed prior to the contractor's year-end, to ensure that credit is maximized:

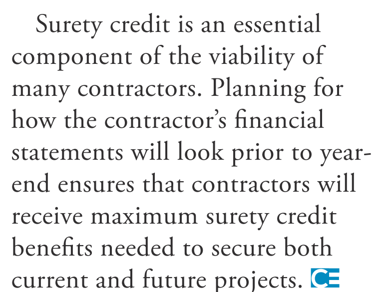
- Focus attention on accounts receivable collections, concentrating on those that will be 90 days past due at year-end.
- Focus on reducing inventory if possible. Inventory needed for completion of current projects,

Types of Surety Bonds:

Type	Guarantee	Damages
Bid Bond	Used by owners to prequalify contractors. Certifies that, if awarded the bid, the surety believes that the contractor has the ability to perform the work.	If the contractor is awarded the project but decides not to sign the contract, the surety is required to pay the owner the difference between the winning contractor bid and the next lowest bid.
Performance Bond	Guarantees the contractor will complete the project as specified by the contract.	If the contractor deviates from the contract terms, the surety must reimburse the owner for any losses resulting from the deviations.
Maintenance Bond	Guarantees against faulty workmanship or materials. The maintenance bond is usually valid for one year after construction is completed.	The surety must reimburse the owner for any losses incurred by the owner related to faulty workmanship or materials.
Payment Bond	Guarantees payment to subcontractors and suppliers. The owner will receive the project free and clear of any liens from unpaid subcontractors or suppliers.	The surety must pay any subcontractor or supplier if the contractor fails to pay.
Completion Bond	Guarantees the contractor will perform and deliver a project that is free and clear of any liens associated with the work performed under the contract.	If the contractor fails to compete the project, the surety is required to find another contractor to complete the project to the contract specifications.

as well as bidded jobs, should not be considered for reduction.

- Call loans in an effort to decrease the amounts owed by stockholders or related parties and entities prior to year-end, as this affects both working capital and stockholders' equity.
- Review and reduce items that create prepaid expense assets. An example of a prepaid item that could be addressed prior to year-end is prepaid insurance. If policy renewal lands prior to year-end, this could have a significant impact on surety credit. If the policy renewal is changed to a date after year-end, the prepaid amount would be incurred subsequent to year-end and not have a detrimental impact on the surety-adjusted working capital.
- If a stockholder has loaned the company funds, have the stockholder subordinate the amount to the surety. This transfer will have a significant effect on the contractor's surety credit. If, for example, a stockholder loans the company $100,000 and subordinates the loan to the surety, the impact could be anywhere from an additional $1 to $2 million increase in surety credit.



Surety credit is an essential component of the viability of many contractors. Planning for how the contractor's financial statements will look prior to year-end ensures that contractors will receive maximum surety credit benefits needed to secure both current and future projects. CE

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