# Maximizing Contractor Capital for Increased Bonding Capacity

By Robert Mercado and William A. Clark Jr.

Accounting , Surety

Many contractors rely heavily on surety credit, also known as bonding capacity, in order to bid and win projects. It is important to understand how surety credit is calculated and what efforts can maximize that credit.

Surety credit is based on what is known as the “three Cs”: character, capacity and capital. The surety industry monitors the character of the contractors to whom it extends credit. Less-than-impressive character can have significant impact on surety credit. Contractor capacity refers to the equipment and resources belonging to the contractor. It also refers to the type or size of contracts completed by the contractor. If a contractor is looking to secure a $15 million contract but the largest contract the contractor has completed to date was only $5 million, the surety may be concerned about the contractor’s capacity to deliver a project of that size. Capital refers to the working capital of the contractor, adjusted for certain items, as well as the contractor’s equity.

Under Generally Accepted Accounting Principles (GAAP) in the United States, working capital is the difference between the contractor’s current assets and current liabilities. For surety credit purposes, adjustments are made to the GAAP working capital to determine the adjusted working capital. The surety will typically calculate surety credit based on the contractor’s year-end audited or reviewed financial statements. Surety credit normally ranges from 10 to 20 times the lesser of the adjusted working capital or equity of the contractor. To maximize surety credit, it is imperative to identify the items that affect the calculation.

**ACCOUNTS RECEIVABLE OVER 90 DAYS**

Receivables over 90 days are normally removed from working capital for surety purposes unless the contractor can show that the receivables have been collected from the customer. Throughout the year and, more importantly, prior to year-end, contractors should focus on collecting any receivables that will be in this 90-day-plus bracket as of their year-end.

**INVENTORY**

The surety will remove from working capital 50% to 100% of inventory carried on the contractor’s financial statements. Contractors should try to have a minimal amount of inventory on hand as of their year-end.

**NOTES RECEIVABLE FROM UNRELATED PARTIES**

Notes receivable from unrelated parties are frowned upon by sureties. If a note receivable is on the contractor’s balance sheet, the surety will look into the credibility of the party from which the note receivable is due, in order to determine if it will be included as part of the working capital.

**LOANS AND NOTES DUE FROM RELATED PARTIES**

Amounts loaned to related parties, including affiliated companies or relatives of the stockholder(s) of the contractor, are removed from working capital by the surety. Prior to the contractor’s year-end, any amounts owed from related parties should be repaid or reduced to minimize any impact on working capital.

**PREPAID EXPENSES**

For surety credit purposes, prepaid expenses are removed in their entirety from working capital. Based on this, it would be prudent to conduct a review of all items creating a prepaid expense and determine if changes can be made to reduce the potential for any prepaid expenses at the contractor’s year-end. An example of this is general liability and workers' compensation insurance. If the renewal period is just prior to the contractor’s year-end, the prepaid premium could be very large. A simple change to the policy’s year-end to fall after the contractor’s year-end could reduce the reporting and impact of prepaid expenses.

**CASH SURRENDER VALUE OF LIFE INSURANCE (CSV)**

A contractor's ability to access cash is important to the surety. CSV is considered part of adjusted working capital, making it a short-term asset, as compared to GAAP, under which it would be a long-term asset. The CSV would be net of any loans the contractor has taken against the CSV and any applicable surrender charges.

**LOANS PAYABLE TO STOCKHOLDER(S)**

If the contractor's adjusted working capital or equity is not at the level needed to sustain the surety credit required by the contractor, the surety may require the stockholder(s) of the contractor to loan the company funds for working capital purposes. This loan would increase the cash position of the contractor, which then increases the working capital. The loan would then be required to be subordinated to the surety, meaning the contractor would be required to get permission from the surety to repay the stockholder(s).

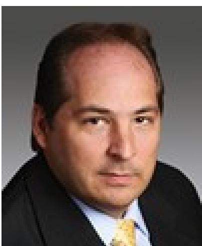
**LINE OF CREDIT**

Sureties o en require contractors to obtain a line of credit with a bank. The line of credit normally does not increase the working capital of the company but allows the contractor to obtain cash if needed. This provides financial security to the surety that the contractor will have funds, if needed, to complete projects.

**EQUITY**

The equity of a contractor is the amount shown for GAAP purposes, reduced by any loans or notes due from related parties or increased by any loans from stockholders to the company that have been subordinated to the surety.

There are many crucial items that impact the contractor's capital for surety purposes. With proper planning prior to the contractor's year-end, construction companies have a multitude of options that can enhance their capital position in order to maximize surety credit.



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