

[NOVEMBER 2007]

EXECUTIVE

Construction

Annual Contractors' Guide to

SURETY

BONDS

Including the
2008 Directory
of Contract
Surety Bond
Brokers

TRISTAN PAVIOT/GETTY IMAGES

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2007 Surety Market

Construction expansion has been strong and is now moving into its third year. Can contractors maintain the pace? Is the surety industry prepared to continue supporting this expansion?

Looking back to August 2006, non-residential construction spending was up 17.1 percent, according to the U.S. Census. Four months later, nonresidential construction spending rose 12.7 percent, and by May 2007, it increased 15.4 percent. In July 2007, nonresidential construction spending was still up 13.9 percent.

Surety industry executives have a unique vantage point, and from where they sit, no slowdown is in sight.

CONSTRUCTION ECONOMY

The lodging, office, commercial, health care, education, public safety, transportation, communication, power, and conservation and development sectors all enjoyed double-digit gains in July 2007 compared to the previous year, according to the U.S. Census.

"It is difficult to find a segment of the nonresidential construction industry that is not experiencing growth in both public and private sectors. We see this trend continuing at least for the next 24 to 30 months," says Terry Lukow, executive vice president of Travelers Bond, Construction Services. "The only hesitation is that a major event would not structurally change the economic environment that we're in now."

Doug Hinkle, chief underwriting officer of CNA Surety, concurs. "Over the past two years, we have seen extraordinary construction activity across the country with contractors running at capacity or near capacity," he says. "Fortunately, because of favorable supply and demand relationships, the increased construction activity is often coming with increased profit margins, which makes it easier for sureties to respond favorably to growth in a contractor's bond program."

Some industry executives believe the strong construction economy may last even longer. "With exception to the slumping residential market, we see the construction boom continuing well into 2009," says Michael J. Cusack, senior vice president, managing director and operations board member of Aon Construction Services Group.

With the exception of the upper Midwest—particularly Michigan, which is affected by the struggling auto industry—the strong growth across most regions may reflect the considerable need for public infrastructure projects and for community schools, hospitals and other facilities.

And, given the tragic Interstate 35 bridge collapse in Minneapolis, the focus

on infrastructure inadequacies may direct attention to long overdue improvements.

The entire country has more work in the pipeline. Contractors in the Pacific Northwest, for example, are reporting at least a full year of available work, which is stretching the capacity of the construction industry. With all of the opportunities, contractors must choose projects that maximize their return on investment of funds and personnel. Communication with surety executives is especially important to ensure everyone is on the same page with the business plan and future work opportunities.

Successful contractors regularly discuss a clearly defined business plan with their surety and measure all deviations from this plan. They know their costs and, given the strength of financial controls in place, are capable of compiling accurate financial projections. Their actual results also consistently track favorably to the communicated projections.

"The recurring theme here is that the most successful contractors surround themselves with professionals who are capable of supporting the information needs of their planning process and also provide the necessary guidance to accurately quantify risk and the exposures inherent in the construction business," says William A. Marino, chairman and CEO of Allied North America. "The contractors who are most successful with their surety partners are the ones who leave nothing to chance."

OVERVIEW

BY MARC RAMSEY



TOSHIIHIDE GOTOH/PUNCHSTOCK

Contractors are becoming better business-people, surety executives observe. Systems have improved immensely, and contractors are more educated in the entire process than ever before. "Contractors have just become better managers with their businesses and their money," notes Rick Kinnaird, chair of the board of The Surety & Fidelity Association of America (SFAA), and senior executive, surety, of Westfield Group.

A contractor's bank relationship is also important. "Banks are already tightening consumer loan terms and conditions, and changes to small contractors won't be too far into the future," says Michael F. Greer, vice president, surety and fidelity, of Penn National Insurance Co.

"Contractors really need to make sure their bank relationships are sound. People forget what happened back in the 1980s when bank credit was scarce. If a bank pulls or changes the terms of a bank line of credit and the contractor is extended on its biggest job ever, there could be dire consequences. Contractors who tightly manage their cash flow and collect their receivables will be much better off if credit conditions continue to deteriorate."

CAPACITY AND AVAILABILITY

The No. 1 issue that has emerged from the continued robust construction economy is the lack of human resources. Before extending surety capacity, sureties must be certain a contractor employs enough quality people to carry out its business plan. "Construction companies are developing more programs," says Thomas Kunkel, president and CEO of Travelers Bond. "They're doing everything they can to add value to keep better employees in place."

Work programs are another issue. Sureties may challenge acceptable levels if too much work develops too quickly. Sureties are looking for respectable profit margins from their contractors with full work programs. "Project selection is paramount in this scenario where there is strong construction funding and numerous projects coming out for bid," Kinnaird of SFAA explains.

The size of single projects today also presents challenges. "It is staggering," says William Cheatham, president of Zurich North America Surety. "We are seeing bigger and bigger projects, and the biggest concern is surety capacity. There doesn't appear to be the capital influx necessary to expand capacity for high limits of surety

credit. Occasionally, capacity has been managed to date by owners requiring bonds at less than 100 percent of contract price."

Small Market (Under \$10 Million)

Surety executives emphasize that while fewer sureties may be willing to write small market contractors, plenty of competitors have the capacity to support bonding needs under \$1 million and up to \$10 million. Underwriting may be more stringent than for other markets, and indemnity is required in most situations.

"There is adequate capacity for small and emerging contractors in terms of being able to get bonds," says Henry W. Nozko, Jr., president of ACSTAR Insurance Co. "The difference is the terms and conditions are usually less flexible than for the other groups."

While some executives say capacity and availability have not materially changed for this market, others indicate the marketplace is expanding as underwriters move down to the smaller contractor arena, improving availability.

Smaller contractors should demonstrate a certain level of experience and sophistication and have access to capital to improve their ability to obtain surety support. Without reasonable levels of committed capital, sureties tend to be less willing to extend credit based on projected earnings and prospective growth of the balance sheet.

In addition, smaller contractors should look for a surety company that is dedicated to this segment of the market and has the ability to grow with the contractor. "Small contractors that are interested in growing can benefit greatly from choosing a surety that has the experience and capacity to understand their unique needs and can provide dedicated support for their business development at all stages," says Lloyd Geary, vice president of Ohio Casualty Bond, a division of Liberty Mutual Group.

For contractors that may not be able to obtain bonding through traditional means, SFAA's Model Contractor Development Program can help. Many states and project owners have embraced this program to encourage contractor development.

Working closely with a professional surety bond producer and surety underwriter is particularly important to get construction companies off on the right foot. It is a critical time for construction companies to gain knowledge about stan-

dard underwriting requirements needed to grow their organizations. With the surety bond producer's and underwriter's strategic partnership, many of these contractors have the potential to become the next generation of movers and shakers in the construction industry. Some sureties are attracted to smaller construction companies precisely for this reason.

Middle Market (Around \$50 Million)

The middle market remains the most competitive, and is the level at which most surety companies want to participate. Capacity is readily available to handle qualified contractors with surety needs in this range, surety executives say.

"Many surety companies that kept their market focus in small business now have moved up into the core middle market business," Lukow says. "As competition increases—and there is no question it has in this area—we are seeing deterioration in underwriting standards."

Contractors at this level normally have strong relationships with business partners, including bankers, lawyers, surety bond producers and surety underwriters. They have frequent interaction with surety decision-makers.

At this level, sureties look for greater sophistication in estimating, recordkeeping and quality audited financial reports, strong senior leadership, project and field management, and well-developed business succession plans. Contractors also must have proper debt-to-equity and backlog ratios.

Large Market (Around \$100 Million)

The upper end of the middle market and the large market will remain competitive segments of the surety industry.

"Contractors in the \$100 million and up segment are growing at a faster rate than those in the small to middle market segments," says Dennis Perler, president of Liberty Mutual Surety. "As they expand, contractors often stair-step their backlogs, outpacing their financial balance sheets and stressing their leverage ratios until job profits are realized. As this occurs, contractors need to consider balancing financial strength improvement with backlog capacity growth. Contractors that can rationally demonstrate their capabilities to assume larger programs to their sureties, however, should find adequate capacity is available

Top 10 Writers of Surety Bonds—2006

Company	Direct Premium Written (Millions \$)
Travelers Bond	\$941
Zurich Insurance Group	\$444
CNA Insurance Group	\$418
Safeco Insurance Group	\$360
Chubb & Son Inc.	\$276
Liberty Mutual Insurance Group	\$260
Hartford Fire & Casualty Group	\$206
Arch Capital Group	\$142
HCC Surety Group	\$131
American International Group	\$121

*Includes contract and commercial surety

Source: The Surety & Fidelity Association of America, "Top 100 Writers of Surety Bonds—United States & Territories & Canada," 2006 (Preliminary)

to meet their needs and to work through these stretch periods."

The capital structures, reinsurance arrangements and net retention strategies of most underwriting companies dictate a business plan that is focused on developing relationships with construction firms with sales in the \$50 million to \$150 million range. "Based on the broader competition in this space," Cusack notes, "contractors may see more underwriting flexibility from sureties on issues such as surety rates, work programs, minimum capital thresholds and personal guarantees."

Mega Market (Exceeding \$250 Million)

Projects in this market present a wide range of risk from contractual, duration, funding, capital and organizational strain. A loss occurring at this level could be detrimental to many sureties continuing in the surety and construction markets. Understandably, underwriting standards are at the highest level, and financial wherewithal is more of a driving factor in the decision-making process. However, most surety executives are confident the sureties in this market can handle the program needs of contractors that require capacity in this range.

While the competitive pool of sureties willing to take risks gets smaller as project sizes move up the spectrum, little doubt exists that there is more than enough capacity to handle the needs for construction companies with the right balance sheet, strategic business plan and human resources talent.

"Whereas increased contractor financial and management sophistication in

communicating information with sureties is important in the \$100 million-plus segment, it is even more beneficial for jumbo contractors to proactively engage their surety partners due to the substantial exposures taken on by the sureties," Perler says.

The surety industry has been responsive to providing 100 percent performance and payment bonds for the right project and team of contractors on projects costing near \$750 million. "Although no new players or capital has come into the surety industry, existing markets have marginally increased their support for the qualified contractor or consortium under responsible contract terms and conditions," says Terrence Cavanaugh, senior vice president and managing director of Chubb & Son Inc., and chief operating officer of Chubb Surety.

In the current construction environment, mega-contractors are experiencing strong operating results. Consequently, balance sheets are expanding quickly, which allows growing firms to qualify for more surety capacity. "While the surety industry is trying to meet the credit needs of larger contractors, we find that the industry's flexibility is challenged when the bond needs for any one firm spike beyond \$3 billion," Cusack says.

The trend toward shorter bid lists and higher margins will continue into 2009. The efficient management of human capital remains critical to maximizing profitability. Tight surety credit conditions may continue, but more efficiently managed contracting firms with sufficient scale will

benefit from the confluence of a strong construction economy and disciplined surety underwriting.

SURETY OUTLOOK

The robust construction economy is keeping some contractors' heads above water, but the elasticity of organizational pressure and cash flow buoyancy might be masking problems down the road.

"Adherence to underwriting discipline is what strengthened the positive surety results over the last few years," Cavanaugh says, "and any deviation from that discipline invites a slide back to unfavorable results. The market remains fragile in that one loss, merger, acquisition or scale-back by any player could tighten the market."

Adds Sarah Finn, president of the National Association of Surety Bond Producers, and national surety vice president of IMA of Colorado: "Many sureties, no doubt, appreciate the lessons learned in the early years of this decade when they were suffering significant losses. With competition comes the need to remind ourselves about avoiding the mistakes that produced the last down cycle for sureties."

While the construction economy has been good and has helped mitigate losses, overextension could become a problem if work stays too plentiful. "This is where the surety industry has to keep its discipline and not let contractors take on more work than they can adequately handle," Greer advises. "We are seeing a number of contractors with ample backlogs."

Furthermore, the growth of contractors' backlogs may be outpacing the growth in their balance sheets. "As a result," explains Timothy Mikolajewski, senior vice president of Safeco Surety, "there has been more discussion about ways to enhance the balance sheet with such things as personal indemnity or capital infusions. These discussions are much more typical in today's market."

Fortunately, contractors are carrying record profits along with these record backlogs. "Most contractors have the financial ability to weather some level of financial downturn without the need for their surety to get involved," Mikolajewski says.

Ramsey is communications manager of the Surety Information Office, Washington, D.C. For more information, call (202) 686-7463 or email sio@sio.org.

EXECUTIVE

ANALYSIS AND ADVICE FROM SURETY INDUSTRY LEADERS

Insights

SURETY COMPANIES



THOMAS KUNKEL
President and CEO
Travelers Bond



TERRY LUKOW
Executive Vice President
Travelers Bond,
Construction Services

As the construction economy continues to expand, it puts more stress on contractors to deliver projects. The industry will need talent to meet construction demands—project superintendents, project managers and entry-level positions for all sizes of contractors.

Most of our clients have created specific training programs to accelerate personnel development. This is the critical issue for the construction industry. We have not been in a meeting with a client in which labor shortages, availability of subcontractors and internal human resources capabilities have not been brought up. These topics are so prevalent in our thinking that if the economy continues to expand, it will be difficult for the construction industry to meet market demand.

As contractors grow their backlogs—in number, size and scope—we're spending more time with our clients to understand their project management capabilities, their personnel capabilities and their subcontractor capabilities.



WILLIAM CHEATHAM
President

Zurich North America Surety
We remain consistent in our underwriting so the customer can manage

business effectively. One of the worst things that can happen is for a contractor to be surprised by inconsistent surety underwriting. A contractor can measure a surety's consistency by analyzing underwriting results, leadership stability, capital commitment, and historical underwriting terms and conditions.

Zurich's goal is for our loss ratio to remain low compared to the industry. We attribute our low loss ratio to the decline in contractor failures, the availability of work, consistency in underwriting and improved credit scoring to provide a good underwriting benchmark.

One of the top issues facing the surety industry is a mentality to drive the top line, which could interfere with a disciplined surety underwriting process. If insurance industry executives identify surety products as a profit center opportunity and decide to grow too fast, it could erode the results.



DOUG HINKLE
Chief Underwriting Officer
CNA Surety

More than adequate surety capacity exists for mid-sized and large contractors

with bonded backlogs up to \$300 million. Because of loss results, return on capital and reasonable surplus to exposure relationships, this market sector is an area of focus for many sureties in the industry.

Surety availability for small and emerging contractors will continue to be a challenge. However, some small contractor programs in the marketplace will provide relatively easy terms and conditions for contractors needing bonds that aggregate up to \$400,000.

In the jumbo project arena, few surety players will continue to limit capacity.

Surety industry loss ratios will remain positive for 2007. While it is becoming more competitive, generally, we are still seeing reasonable underwriting decisions and acceptable terms and conditions. Inflation and continued growth in construction spending have generated growth in surety company revenues without creating unreasonably aggressive underwriting and pricing of the surety product. With few exceptions, the industry is enjoying strong profitability, and I expect that to continue through 2008.



TIMOTHY MIKOLAJEWSKI
Senior Vice President
Safeco Surety

A couple of months ago, everything indicated the construction economy would continue to be very robust. Then, the sub-prime

mortgage issue surfaced, and overall credit availability became more scarce. Not only could construction spending in the private sector slow considerably, but contractors may not be able to access capital or liquidity to invest in their businesses.

So, I'm a little less optimistic about the next six months, especially for the private construction market. On the other hand, public works construction will continue to remain strong due to the significant demands for improved infrastructure in the United States.

As long as the construction economy remains strong, we should continue to see contractor failure rates decline, or at least remain steady. In a market where there appears to be plenty of good opportunities, contractors should focus on projects with less competition or on projects with higher margins. Contractors also should focus on building both liquidity and equity in their companies so they are in a solid position to handle the inevitable downturn in the construction economy.



**TERRENCE
CAVANAUGH**
*Senior Vice President and
Managing Director*
Chubb & Son Inc.
Chief Operating Officer
Chubb Surety

This is one of the most exuberant construction economies in quite some time. New York, California, Florida and Texas all are planning or have in progress a major project. Large national and international contractors faced with more than adequate opportunities are selectively choosing the right projects to maximize their return on investment of funds and personnel.

It is critical, with all the opportunities being presented, that contractors create a dialogue with their surety companies to ensure all are aligned with their business plans and pipeline opportunities. The current robust economy is keeping everyone's heads above water, but the elasticity of organizational pressure and cash flow buoyancy might be masking problems down the road.

Adherence to underwriting discipline strengthened the positive surety results during the last few years, and any deviation from that discipline invites a slide back to unfavorable results. The market remains

fragile in that one loss, merger, acquisition or scale-back by any player could tighten up the market.



DENNIS S. PERLER
President

Liberty Mutual Surety

The country is benefiting from an extended period of construction growth, and sureties have played an important part by providing the bonding capacity to get projects completed.

Although economic forecasts indicate continued strength in nonresidential construction into 2008, the economic outlook may become less certain as external economic pressures add business risk to the go-forward construction market. While it is too early to forecast the end of the current construction expansion, it may be prudent to plan for the various contingencies that a changing economy might bring.

Changes such as evolving workforce demographics (including baby boomers moving toward retirement), increased dependency on foreign workers and worker training will strain the construction industry's ability to execute available work. As residential construction wanes, more subcontractors may move into the public sector and increase competition. Moreover, sub-prime-driven credit market problems are expected to impact borrowing costs and, ultimately, private sector construction spending.

Good planning and management, however, can overcome these issues. Contractors that build solid business plans and communicate effectively with their surety companies will find stable surety capacity and continued business success.



HENRY W. NOZKO JR.
President

ACSTAR Insurance Co.

Loss ratios have been good the last few years and are moving toward excellent. Nothing in the landscape indicates loss ratios will return to the way they were in the 1990s. The market is slightly softer, but very healthy.

Reacting to owners' onerous contract terms is as important as having a strong

financial statement. Contractors should demonstrate that they don't just sign contracts, they negotiate contracts to change onerous language. Negotiating favorable, fair terms and conditions is much more appealing to a surety. Contractors must keep control of their work in progress and work backlog. Sureties are very concerned about exposure. The more contractors have on their plate, the more chances for something to break.

Seeking a professional surety bond producer that has a reputation for submitting complete and adequate submissions to the surety will be an advantage to the contractor. Contractors should seek references to make sure they are getting an agent who will be an asset to the firm.

BOND PRODUCERS

WILLIAM F. SIMKISS

Executive Vice President

The Simkiss Companies

We foresee the growth trend in nonresidential construction continuing for the next 12 to 18 months. While much of our experience is drawn from the Mid-Atlantic region and East Coast, the nonresidential construction barometers have been strong in almost every area and every segment. In areas where hyper-growth is occurring, sureties are always concerned about labor and equipment shortages and their effect on a contractor's ability to complete the work it has obtained.

To maximize surety capacity, contractors should develop a cohesive and comprehensive business plan that is reviewed and revised periodically. Sureties are much more likely to provide the necessary support when they are comfortable that they understand overall goals and plans. Contractors also need to communicate effectively and often. Keeping an open dialogue of both the good and bad things occurring within a contractor's business and their effects on the overall business plan is a critical factor in maintaining surety support.

Finally, manage the construction firm and its profitability well enough to make and retain sufficient capital to support the financial needs of the business and allow for any hiring necessary to maintain adequate human capital.



SARAH FINN

President

National Association of
Surety Bond Producers

National Surety Vice President
IMA of Colorado

In today's market, surety credit is available to qualified contractors of all sizes. However, capacity may be a challenge for contractors working on large projects or mega-projects in which significant risk is aggregated. On such projects, co-surety arrangements will continue to be the rule.

The right producer functions as a strategic business adviser—and a guide, educator, matchmaker and counselor—to position the contractor to meet the underwriting requirements for surety credit in the ever-changing and challenging landscape of the construction market.

First, clients must know where they are headed and how they wish to get there. Contractors must have a concrete understanding of their business objectives and how those objectives translate to their organization, structure and resources. They must build their balance sheets, understand their business risks and appreciate how to plan for and manage those risks.

Contractors that demonstrate such understanding are well-positioned to increase their surety capacity once they communicate that interest to their producer and surety.



WILLIAM A. MARINO

Chairman and CEO

Allied North America

Contractors must clearly understand the factors that contribute to the expansion of their work programs. There is a direct correlation between balance sheet growth, successful completion of bonded projects, a clearly defined business plan and the expansion of a surety work program.

The role of the surety broker in this process is to work with the contractor to ensure a firm understanding of expectations, and to regularly communicate with the carrier to ensure the information used to arrive at decisions is accurate and complete. Issues critical to the success of clients include resolution of contract disputes, financial planning, continuity prepara-

tion, identification and prequalification of potential joint venture partners, and management of business and contractual risk that, when managed properly, can result in enhanced financial performance. Our primary objective as a broker is to assist our clients in avoiding contract-related disputes through the proactive management of these exposures.



MICHAEL J. CUSACK

Senior Vice President,

Managing Director and

Operations Board Member

Aon Construction
Services Group

Some of the best-managed construction franchises in the country have a systematic process that ensures efficient management of corporate resources. The more prosperous firms share a specific focus on selectivity in the pursuit of new project engagements and remain committed to servicing the construction needs of desirable, repeat owners.

Firms must resist getting overextended in this boom market. The market calls for a careful prequalification of projects. This screening process should include minimum fee expectations and a review of available resource allocation. As far as the surety credit environment is concerned, contractors should understand no change in the surety marketplace will be apparent for several years. Therefore, margin discipline and efficient resource management will remain critical components of successful business plans.



MICHAEL MURPHY

Executive Vice President

Bush, Cotton & Scott,

a Hub International Company

A very strong construction market and economy have allowed for improved margins on bid and negotiated work. Contractors should have a well-thought-out strategy and risk mitigation plan for the risks associated with continued growth or geographic spread. They also should have an even better thought-out plan to mitigate the impact of adverse results or a sudden or material contraction in their business.

Before a surety extends surety capacity, a contractor should demonstrate timely

communication with its surety and the ability to balance taking on opportunities in a very healthy construction environment with the availability of adequate financial resources, management personnel and tools, a qualified labor pool and price stability of materials.

A contractor also should demonstrate proper due diligence in evaluating owner contracts, particularly clauses regarding actual and consequential damages; price escalation allowances; obligations regarding latent defects; and the statute of repose, especially on condo and certain residential construction.



MICHAEL J. MITCHELL

Vice President, Surety

The Graham Company

Many smaller sureties are more flexible and willing to underwrite smaller contractors. Although these smaller sureties also will have limited capacity and U.S. Treasury limits, they should be adequate to satisfy the needs of smaller contractors.

Mid-sized contractors (under \$50 million) are probably considered the "bread and butter" for sureties. All sureties like to write these mid-sized firms. Sureties can handle these limits, they get a good premium rate, and the overall risk is considered something they can handle in-house (without reinsurance).

Larger sureties are comfortable with large contractors, but they will do more underwriting than for the mid-sized firms. If a contractor has been consistently profitable in the larger project size range, then surety should not be a problem.

If the construction company is young and has gotten to \$100 million too fast, some sureties may realize the balance sheet doesn't support the limits required. In these situations, contractors could be required to retain profits, add equity, joint venture with a partner that has financial strength or offer personal indemnity.

MICHAEL F. GREER

Vice President, Surety & Fidelity

Penn National Insurance Co.

Discussing the subject of surety capacity is similar to having the chicken or the egg conversation. A contractor needs surety

capacity to make money, and a contractor needs money to get surety capacity, so how do both achieve these goals? A contractor must have a business plan and, perhaps more importantly, must know how to execute it. What does the firm do better than anyone else? Can it make better margins than the competition?

Capacity is a problem only for a contractor sailing without sails. Contractors that find a niche, have good cost systems, are safety conscious, bid only on work with potentially good margins, and find, reward and retain good people are the ones that make money. If you make money, sureties will be knocking on the door. Too many contractors think they need volume first.

JEFF BOOTH

Regional Vice President

Allstar Financial Group

Small and emerging contractors can obtain surety credit with a commitment to providing quality underwriting information, including, but not limited to, a quality CPA financial statement.

Take steps to build a good track record of job performance and solid credit. If a contractor has "stumbled" along the way or has unique circumstances, options are still available to obtain a single bond or bond program. Be upfront about any negative issues and open to controls or conditions to support the risk.

Know your territory and don't look at out-of-state work to save a business. Unfamiliarity with a territory is a major cause of contractor failure. Any expansion should be well-thought-out and conservative.

Contractors that are always looking to switch to another surety may hurt themselves in the long run. A long-term relationship has an intangible quality that is difficult to replace. It can be an advantage to have a track record with a surety in the event of a problem. The surety may be more willing to work with a long-term client than a new client.



JOHN C. STANCHINA

**Senior Vice President
and Division Manager**

Rutherford Companies,
an Assurex Global Partner

The commercial construction market remains strong, and the prof-

itability of most commercial contractors is at or near all-time highs. This has translated into excellent surety results for the past two years, and 2007 looks to close as a very good year for the industry as well.

As a result, we are seeing competitive pressures returning to the market. This is mainly in the smaller and middle markets, but extends to large contractors in the \$100 million to \$200 million range. Capacity will continue to be an issue for mega-contractors.

While the commercial market remains strong, the weakening of the residential market is affecting competition in other sectors. For example, civil contractors focused on residential development are looking elsewhere for revenue. This increased competition on commercial site development is putting pressure on margins.

In addition, road construction budgets are tight in many states. Inflationary cost increases on steel, concrete, asphalt and fuel are dramatically reducing the volume of projects available for contractors to pursue. This lack of volume is affecting margins and likely will drive further consolidation in the civil construction market.

As the surety industry further employs the use of credit scoring modeling, contractors need to meet with their surety producers and underwriters to understand how credit scoring works and how it affects the analysis of their financial planning.



STEVEN RAFFUEL

**Vice President—Surety
Practice Leader**

Commerce Insurance
Services Inc.

Capacity and underwriting standards are largely unchanged from the previous couple of years. Underwriting ratios remain stable with adequate capacity for contractors that deserve it. Mega-contractors still face challenges, which can be addressed with multiple co-sureties, but the mega-project still suffers from the lack of full bonding capacity. Small contractors have limited availability primarily due to their limited financial sophistication and management skills.

The robust construction economy will continue due to the escalation of labor and

material costs. It cannot be automatically determined that this translates to more construction. For example, in the New York City area, there is a severe labor shortage coupled with enormous infrastructure spending. As a result, some projects have limited bidders, and those that can bid (and obtain bonding) are banding together with joint-venture partners to share the risk and bonding requirements, and access projects they may not be able to staff by themselves.

If you want an increase in surety bond capacity, build for profit, not for your ego. Be selective about the projects, project owners and general contractors you work with, and communicate consistently. Don't assume the surety looks at things the same way you do.

ADVISERS



ROBERT E. MEADE

Senior Vice President
American Arbitration
Association

When drafting and reviewing contracts, construction executives should be aware of an important change in form construction documents.

The American Institute of Architects will change the dispute resolution clauses contained in its standard form documents. Under the proposed document changes, American Arbitration Association (AAA) mediation is still the mandatory first step. However, arbitration is no longer the default process for the parties to seek resolution of disputes and claims.

According to the new edition, parties will need to affirmatively select arbitration as the means for binding resolution of disputes remaining unresolved after mediation. In the absence of such selection, the parties may mutually agree to choose arbitration or have their claims decided in a court with jurisdiction over the dispute.

Considering that the median time from filing to award of AAA commercial arbitration is less than 10 months (as compared to 22.2 months in federal court), general contractors and other construction professionals should be sure to review the dispute resolution provisions in contracts. (For more information, visit www.adr.org.)



MARK A. SGARLATA
Senior Partner
Watt, Tieder, Hoffar
& Fitzgerald, LLP



**CHRISTOPHER
J. BRASCO**
Partner

Watt, Tieder, Hoffar
& Fitzgerald, LLP

From a litigation perspective, surety risk management begins with the contract documents. Sound risk management principles dictate that the risk of loss associated with any element of a construction program should be borne by the party that is in the best position to control the risk. For example, the project owner is in the best position to understand underground site conditions, and therefore is commonly in the best position to assume this risk.

Accordingly, contract documents should be reviewed to determine whether they contain risk-shifting clauses that seek to allocate risk to a party poorly positioned

to address that risk, or in a manner that is otherwise inconsistent with the project delivery method or industry norm.

Additionally, bond forms should be chosen carefully to preserve a surety's performance options upon receipt of an obligee's notice of default.

During project performance, risk is best managed by monitoring construction progress and maintaining a dialogue, as necessary, with the principal and obligee throughout the performance period.

SUSANNA L. SYRUS

Escrow Specialist
National Escrow

On any construction project, a contractor must focus on performance, meeting construction deadlines, scheduling deliveries, ordering supplies and negotiating subcontracts. This does not leave much time for supervising all back-office functions. It is cost-prohibitive for a small or mid-sized contractor to hire a project-specific accountant for each job. But, surprisingly, the largest risk on a construction project is nonpayment.

How can contractors be sure that earned contract proceeds filter down to the subcontractors and suppliers actually performing work or supplying materials to the job, and no bond claims or mechanic's liens are filed?

By controlling the flow of the contract funds through a construction-based escrow, this risk can be minimized. As funds are earned, they are deposited with the escrow company. The escrow company then works with the contractor to issue proper payments to the vendors and subcontractors that only performed work on the given project. The contract funds are trust funds set aside for specific job costs. Proper fund control provides accountability for those trust funds.

In today's volatile market, all risk needs to be managed. After all, an escrow is like a seatbelt: If used properly, it can help minimize injury, but it cannot stop the accident from happening.

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**WHAT CONTRACTORS
SHOULD LOOK FOR IN BOND
PRODUCERS, UNDERWRITERS**

BY MARC RAMSEY

THE SURETY RELATIONSHIP

Surety is a relationship business. Next to a contractor's financial strength and the ability to perform a job, there may be no more important consideration than its character.

"The more we know about the contractor's organization in all respects, the more likely a surety and producer are to have confidence in the company," says Timothy Mikolajewski, senior vice president of Safeco Surety.

Building a solid relationship with a professional surety bond producer and surety underwriter is critical. It is important to

partner with a bond agent and surety company with matching business philosophies.

"You want to make sure you're starting with the right relationship for the right reason," says William Cheatham, president of Zurich North America Surety. "Ask, 'What's your success record with contractors? What's your personal or corporate expertise? What are the surety company's skills? Does it have a claims department or a risk management department? Does it review terms and conditions of the contract?'"

BOND PRODUCERS

In addition to matching business philosophies, a contractor should find a producer with a similar personality—someone with the skills to handle both sides of a relationship. "A top producer is honest, has the client's best interest at heart first and foremost, and has a deep understanding of what makes a construction firm successful,"

says Michael F. Greer, vice president, surety and fidelity of Penn National Insurance Co. "A top producer is not just someone who says 'yes' all the time. This is one of the worst things that a producer can do to a client. The producer needs to be an adviser, not a peddler of bonds. The producer has to be able to tell the client when a decision is not in his best interest and where the possible pitfalls are."

Contractors should search for a producer in the same manner they would seek a trusted business adviser. Look for producers with a reputation for integrity, experience with contractors and subcontractors, and specialized knowledge of contract surety markets.

"They also should demonstrate active commitment to and participation in construction and surety trade organizations such as Associated Builders and Contractors and the National Association of Surety

Bond Producers (NASBP)," advises Sarah Finn, president of NASBP and national surety vice president of IMA of Colorado.

A producer functions as an objective resource and sounding board for a contractor, providing invaluable advice and guidance, so that a contractor puts its best foot forward with a surety. A producer evaluates a contractor's organization and financial strength, provides referrals to other specialized consultants, such as CPAs and attorneys, and fosters productive, solid relationships with surety underwriters to meet the contractor's surety credit needs.

A good surety agent is a communicator who understands the desires and expectations of both a contractor and surety. "The agent should be experienced and knowledgeable of the marketplace and the trials, tribulations and successes that have come over time in this cyclical business," says Terrence Cavanaugh, senior vice president and managing director of Chubb & Son Inc., and chief operating officer, Chubb Surety. "A good producer should have integrity and be trusted that any information shared stays among the parties who need to know."

Contractors should know the producer's and surety's commitment to the business. "The most important characteristic of a surety bond producer is having broad access to the surety marketplace," says Michael J. Cusack, senior vice president, managing director and operations board member of Aon Construction Services Group. "Therefore, the most important issues that a contractor should understand in choosing a surety broker are: 'What coverage of the surety marketplace does the producer provide? Does the bond producer have numerous relationships? Or, is the firm's access restricted by a limited number of business contacts in the industry?'"

Contractors should look for a bond producer who deals directly with the surety that is providing a bond and who has a reputation for submitting complete and adequate submissions to the surety. In addition, surety bond producers are well-connected to the community in which the contractor lives.

"They know other contractors in the area and have a good reputation for prompt service," says Rick Kinnaird, chair of the board of The Surety & Fidelity Association of America (SFAA), and senior executive, surety, of Westfield Group. "They understand and know the owners/obligees who



require bonds and the various nuances associated with their contracts and bond forms."

SURETY UNDERWRITERS

A surety underwriter must provide knowledge, experience and open and honest communication so a contractor can execute its business plan.

"Contractors can benefit from the advice offered by a surety," says Jeff Booth, regional vice president of Allstar Financial Group. "The surety has the contractor's best interest in mind because, if the contractor fails on the project, the surety is on the hook. Listen to advice on bond forms and contract language because in most cases, as the owner of the company, you are personally indemnifying the surety should a claim happen on the project."

A surety should be viewed as a partner that provides value to contractors in the form of job-specific analysis, along with contract and bond form reviews. The surety is a financial partner that focuses on fiscal responsibility and maintaining a prudent balance between a contractor's resources and project opportunities.

Furthermore, sureties are a value-added resource offering technical support services, such as legal advice, forensic accounting expertise, management information systems and field engineering, to help contractors identify potential problems and more efficiently manage challenging situations.

At the most basic level, sureties want strong balance sheets and experienced management teams. "However, when you drill down beyond the financial and experience factors, underwriters want to forge lasting relationships with contractors," Cusack says. "Bonding companies want to have the ability to meet with customers, review business plans and openly discuss areas of concern."

To truly help a contractor, an underwriter must know how a client thinks, what

motivates a client and what a client can and cannot do. "This level of knowledge comes over time, so the underwriter needs time to get to know the contractor," Greer says. "The underwriter needs to hear how the contractor thinks about various issues, and the underwriter needs a contractor who is willing to listen to what can go wrong."

Some underwriters bring a wealth of knowledge of what works and what doesn't work. Some underwriters are willing to share this knowledge with contractors and agents who are willing to listen. "A good underwriter instills knowledge and ideas on its clients without appearing to preach," Greer says. "A good underwriter is like having a good business adviser. You just have to be willing to listen."

An underwriter also brings experience to default situations. "We don't like defaults," Kinnaird admits, "but we do have them. There is risk involved and we are not perfect. The key is to learn from our experiences of the past and to pass on that knowledge. This information can be beneficial in helping other contractors avoid some of the pitfalls."

An underwriter also should bring expertise on contractual risk and offer insight about how the contractor performs in relation to the greater construction community.

"Our people actually do a benchmarking session with clients and compare them to other contractors to give constructive feedback about overhead, and this is what the industry is doing," says Thomas Kunkel, president and CEO of Travelers Bond. "A good underwriter goes beyond providing a bond. He provides greater involvement."

Remember that surety bond producers and surety underwriters are business partners. It is important for them to see bonded contractors succeed. They want to celebrate financial victories with their customers, and they want to understand why some business objectives might fail. They appreciate having the ability to share their broad view of the marketplace and years of experience with their customers.

Adds Cusack, "They want their clients to succeed, and they want to help their customers minimize learning curves in their pursuit of business opportunities."

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USING BONDING

As a Business Tool

BY MARC RAMSEY

Smart contractors use their bonding capacity as a marketing tool. They explain exactly what “bonded contractor” means for a client—that an objective, third-party surety company has thoroughly vetted the business, examining the three Cs (capital, capacity and character), and determined the company is worthy of receiving surety credit in the form of bid, payment and performance bonds.

ARTPARTNER-IMAGES/GETTY IMAGES

“They convey that message in their marketing materials and in discussions with prospective clients,” says Sarah Finn, president of the National Association of Surety Bond Producers (NASBP), and national surety vice president of IMA of Colorado. “In this way, they relate that they are higher quality contractors, doing what is needed to invest in the long-term success of their companies and differentiating themselves from companies that have not made the investment to merit surety credit.”

In today’s marketplace, surety bonding is a valued financial resource. Only well-managed, well-capitalized firms have access to significant bonding capacity. The ability to bond work in a tighter credit cycle confirms that a contractor has the financial and personnel resources needed to complete a project successfully.

“That surety affirmation is clearly a line of demarcation between the ordinary and strongest firms in the construction industry,” says Michael J. Cusack, senior vice president, managing director and operations board member of Aon Construction Services Group.

Having surety capacity can eliminate competition with contractors that are not

**Only well-managed,
well-capitalized
firms have access
to significant
bonding capacity.**

qualified for the project; helps contractors acquire work for which they otherwise would not be eligible; and provides a contractor strategic business advisers unavailable to the non-bonded contractor.

“If contractors want to do public work, they need surety bonds,” says Timothy Mikolajewski, senior vice president of Safeco Surety. “Beyond that, there is a tremendous amount of knowledge the surety producer and surety underwriter have that can be shared with contractors to help them manage their businesses better.”

Adds Terrence Cavanaugh, senior vice president and managing director of Chubb

& Son Inc., and chief operating officer of Chubb Surety: “The surety relationship should be one of a trusted and dependable business partner/adviser and should be viewed and utilized as such.”

Using surety capacity as a business tool also means treating it like an asset—like equipment or cash—and making business decisions on how to allocate that asset. “That’s where it becomes a tool,” explains Terry Lukow, executive vice president of Travelers Bond, Construction Services. “In today’s marketplace, no contractor has a finite pool of capacity, so how can the contractor allocate this asset to get the best return possible?”

Bonded contractors should be proud of their ability to obtain surety credit. “Our customers like to sell to their owner that they have the ability to provide surety coverage,” says William Cheatham, president of Zurich North America Surety. “It’s how they differentiate themselves from their competitors.”

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Ten Things

BY MARC RAMSEY

Contractors Should Know Before Seeking **Extended Surety Capacity**

In today's hot construction market, contractors have the opportunity to expand beyond their comfort level to new construction markets. But, construction firms must question if a surety would support extended surety credit for new projects. Before approaching a surety about extended surety capacity, a contractor should:

DAVID GOULD/GETTY IMAGES

1. Get to know its surety bond agent and surety company underwriter. When considering a change in geographic regions, scope of work or project size, involve an agent and underwriter and listen to their advice.

2. Maintain and pursue work within the capabilities of its financial and organizational resources.

3. Work with other construction professionals, such as a banker, CPA, attorney and insurance agent.

4. Take advantage of the robust economy to increase profit margins and build the liquidity and equity of its operation. Strengthen financial statements, stay focused on the bottom line and grow the company's equity base every year.

5. Provide proven profitable results by presenting historical project analysis as evidence of success. Demonstrate a track record of higher than normal profit margins in firm-specific markets.

6. Confirm that its surety providers have the capacity to support more ambitious work programs. If a surety partner has the capacity and appetite to support larger backlogs, focus on creating a clear business plan that outlines the specific tactics and broader strategy the company will follow in order to create the desired corporate trajectory and operating results. Maintain open lines of communication with a surety to proactively build support for a business plan.

7. Present a complete application to the surety. A contractor with good financials and a proven track record, but a poor presentation, may get less surety credit than a contractor with a strong presentation. Work closely with a surety bond producer to strengthen this presentation. Provide quality information and responses when requested or, better yet, before the surety makes a request.

8. Provide quality, detailed financial statements, work-in-process and completed job schedules, cost controls, business

planning (including business perpetuation) and talented, proven field management. A contractor also should explain the non-bonded work in its backlog. A surety will want to know how that work was obtained. (Was it negotiated with longtime owners where the risk would be considered low?)

9. Rely on more than bank support to finance daily operations.

10. Hire the best employees, and let them perform.

Increased bonding capacity is made available to well-managed firms that demonstrate the ability to adhere to a business plan, effectively manage resources, report timely and accurately, and show a commitment to increase their balance sheets.

Remember, bond agents and surety companies are strategic business partners that want you to succeed.

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Bonding

BY MARC RAMSEY

OUT-OF-STATE

Projects

FOLLOW THIS ADVICE BEFORE ENTERING A NEW MARKETPLACE

Contractors considering bidding on out-of-state work should always question their motives.

"Surety capacity is not limited to your own backyard," acknowledges Terry Lukow, executive vice president of Travelers Bond, Construction Services. "But you have to ask, why—if the market is so robust—do you feel like that is the best way to allocate your surety capacity?"

Does the firm have a solid rationale for pursuing work out of state? Is it prepared to enter a new market? Has the firm researched the local subcontractor market? Does it have the proper personnel and pro-

cesses in place to succeed in that market? Has it strengthened its balance sheet in light of unforeseen risks?

"Contractors demonstrating such foresight and planning are more likely to obtain the requisite bonding for projects in new markets," explains Sarah Finn, president of the National Association of Surety Bond Producers (NASBP), and national surety vice president of IMA of Colorado.

All construction is local. Many contractors that attempt to penetrate a new marketplace underestimate the learning curve involved in playing what amounts to a firm's first "away game."

To minimize the risk and frustration involved in doing a major job outside of a firm's normal operating region, Michael J. Cusack, senior vice president, managing director and operations board member of

Aon Construction Services Group, recommends contractors adhere to the following approaches:

- travel with a repeat owner/client;
- involve a local joint venture partner;
- try to use a mixture of existing subcontractor relationships and newer firms;
- look to a major subcontractor to help with local relationships;
- integrate long-standing employees with employees hired in the new location;
- limit expansion to one new region at a time; and
- try to limit the scope of the project engagement to a skill set that is well within the firm's past experience and core competency.

"You must be familiar with the marketplace opportunities, pitfalls and nuances that will impact the success or failure of your

construction company,” advises Terrence Cavanaugh, senior vice president and managing director of Chubb & Son Inc., and chief operating officer of Chubb Surety.

Also remember that construction is really a provincial type of business. “Practices that work with owners and subcontractors in one area of the country may not work in other areas of the country,” says Timothy Mikolajewski, senior vice president of Safeco Surety.

Michael F. Greer, vice president, surety and fidelity, of Penn National Insurance Co., says contractors should ask: “How fair and equitable is the new owner? Why can’t the local contractors do the work? Do the locals know something that you don’t? What can an out-of-state contractor bring to the table that no one else can? Can you get enough of a profit margin and contingency in your price to cover the mistakes you are bound to make on your first couple of jobs?”

When pursuing out-of-state work, Greer recommends making sure it is a small project that can’t endanger the entire business.

Adds William Cheatham, president of Zurich North America Surety: “Dive deep into the project to find the risks within

your own organization and the skill level of your people, and present the risks and why it is advantageous to go out of state as opposed to staying in state.”

Sureties will look for some connection between the new region and the contractor, such as knowledge of the labor markets, subcontractors, suppliers, local politics and the legal environment.

“A surety is going to be looking for a strong underwriting case from a contractor seeking to expand its geographic reach to untested markets,” says Rick Kinnaird, chair of the board of The Surety & Fidelity Association of America (SFAA), and senior executive, surety, of Westfield Group. “Sureties will encourage the contractor to ease into new markets, taking on smaller projects to get a working understanding of the new territory.”

Experience has demonstrated a number of recurring themes that contribute to contractor failure, and operating outside of a contractor’s normal territory is one. Whenever a construction company works outside of the arena that has contributed to its success, it must accurately assess the risks associated with the departure from standard operating procedures.

“Failure to properly identify, quantify and price these exposures can have a catastrophic financial impact,” says William A. Marino, chairman and CEO of Allied North America. “When requesting surety support for an out-of-territory project, underwriters will want to gain an understanding of how issues such as labor and subcontractor relationships will be managed. We find that successful contractors are skilled at making difficult decisions, and unsuccessful ones unknowingly make uninformed ones.”

Henry W. Nozko, Jr., president of ACSTAR Insurance Co., says pursuing out-of-state work is not a big issue as long as the contractor has some experience in the market sector. “If a contractor has never done a job out of state, most surety companies will not say ‘no.’ It can’t be the largest or most lengthy job they’ve done. If it’s in terms of what is usual for that contractor, the surety will probably be supportive,” Nozko says.

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What Different ACCOUNTING Methods Show Your Surety

BY BERNADETTE BRITZ-PARKER

A contractor's financial condition is critical to the underwriting process. Financial statements must present an accurate picture of a company's financial health.

Internally prepared financial statements generally are comprised of a balance sheet and an income statement. The balance sheet includes all assets and liabilities (segregated into current or long term) and equity of the company, and shows a snapshot of a specific date, such as the last day of the year. The income statement, also known as a profit-and-loss statement, includes revenues, expenses and net income for a period of time, such as the month, quarter or year.

Contractors may choose from several different accounting methods depending on the requirements posed by their sureties. Contractors commonly subscribe to three methods: cash basis, accrual and percentage of completion.

CASH-BASIS METHOD OF ACCOUNTING

Cash-basis financial statements are the simplest and least informative of all statements. The balance sheet shows only cash on hand and usually fixed assets and long-term liabilities. The income statement tells only what revenue was received and what

expenses were paid. Other current assets or liabilities (e.g., accounts receivable or accounts payable) are not included. This document is based on cash flows and cash position. Revenue is recorded when cash is received, while expense is recognized when the bill is actually paid.

Although this method does not present the true financial condition, it is the simplest method for organizations that do not have a significant amount of transactions or for those with a short lapse between the time service is rendered and payments are made.



COMSTOCK IMAGES/PUNCHSTOCK

ACCURAL METHOD OF ACCOUNTING

Accrual-basis accounting is closer to presenting a true financial picture—recording revenues when earned and expenses when incurred. This method requires financial events to be recorded as they relate to net worth. Even though cash is not received or paid in a credit transaction, it is recorded (i.e., as an accounts receivable or an accounts payable) because it affects the financial future of the contractor.

For example, an expense is recorded when an invoice is received, and revenue is recorded when an item is billed. Although this method is more informative than the cash-basis method of accounting, it still is not a true financial picture for a contractor because it does not consider individual contracts, address percent complete, record over-billings or under-billings, or record a loss in full on a contract in process at the moment the contract is known to be a loss contract.

PERCENTAGE-OF-COMPLETION METHOD OF ACCOUNTING

The percentage-of-completion method of accounting is the only method that presents a true financial picture for a contractor involved in long-term contracts. (A long-term contract begins in one fiscal period and is completed in a different fiscal period.)

Sureties prefer contractors to use the percentage-of-completion method of accounting for financial statements.

The percent complete generally is determined using the cost-to-cost method, which recognizes contract revenue based on costs incurred to date versus total estimated cost to complete the contract.

For instance, if a contract is estimated to cost a total of \$100,000 and \$40,000 in costs have been incurred, the job is 40 percent complete. Accordingly, 40 percent of the total contract price should be recognized as revenue. If more than \$40,000 has been billed on the contract, the overage is an over-billing, which is a current liability on the balance sheet. Conversely, if less than 40 percent of the total contract price has been billed, the shortage is an under-billing, which is a current asset on the balance sheet.

The best-of-class contractors are over-billed, without exception. Large under-billings generally indicate the contract is a loss contract.

**Sureties tend to favor
audited financial
statements because
they are more likely
to be materially free
of misstatements
compared to
compilations or
reviews.**

**COMPILED FINANCIAL STATEMENTS**

Statements prepared and maintained by an in-house construction contractor provide sureties with the least level of comfort. Prior to settling on this method, it is suggested that a third party, such as a CPA, review the documents to increase their credibility. If a contractor decides to have a CPA issue its in-house financial statements, compiled financial statements are the result.

This document provides a general understanding of the contractor's business transactions and accounting records, the method of accounting used for the financial statements, as well as their form and content. Compiled financial statements also may be issued with or without note disclosures.

These statements provide the fewest representations, as a CPA is not required to verify, corroborate or review the accounting records provided by a contractor. In other words, a CPA is not required to be independent and does not provide an assurance as to the accuracy of the statements, although that lack of independence must be disclosed. If a CPA discovers, during its

compilation of financial statements, some items are unsatisfactory for any reason, the CPA must obtain additional or revised information or withdraw from completing the compiled financial statements.

REVIEWED FINANCIAL STATEMENTS

Reviewed financial statements also are prepared by a CPA. Most sureties require reviewed financial statements at a minimum.

These documents provide the surety with a higher degree of assurance because the reliability of the financial statements is determined as a result of various procedures, including primary inquiry and the performance of analytical procedures. However, a review does not include independent third-party verification of contract amounts, change orders or percent-complete or accounts receivable balances.

In a review, a CPA does not document internal control, and therefore has no responsibility to assess the adequacy of the client's system of internal control or test to determine if the system is operating as designed. Additional documents also are generally included, such as a cash-flow statement, schedule of contracts completed, schedule of contracts in process, and detailed notes about a contractor's operations and financial situation. A CPA who is not independent cannot issue a review report.

AUDITED FINANCIAL STATEMENTS

Also known as a financial audit, audited financial statements include an examination by an independent CPA. Depending on the size of a contractor and the amount of bonding needed, many sureties today insist on audited financial statements. This examination results in the publication of an independent auditor's opinion, which declares whether the financial statements are fairly stated, in all material respects, in accordance with generally accepted accounting principles.

Audited financial statements afford the highest level of assurance that the data is fairly presented. Auditing standards dictate the procedures an independent auditor must perform and include documentation and assessment of the system of internal control, assessment of audit risk, independent third-party verification of financial data through confirmations, correspondence with the company's legal counsel, substantive testing of account balances and

subsequent event testing through the audit report date.

Audited financial statements presented to a surety typically include:

- Accountant's opinion page that discloses whether the statements were prepared in accordance with generally accepted accounting principles and generally accepted auditing standards.
- Balance sheet that includes the assets, liabilities and net worth of the business as of the date of the statement. This sheet helps a surety evaluate the working capital and overall financial condition of a contractor.
- Income statement that measures how well a business performed during the last fiscal year. A surety analyzes each item, including gross profit on contracts, operating profit and net profit before and after the profit was taxed.
- Statement of cash flow that discloses the cash movements from operating, investing and financing activities.
- Accounts receivable and payable schedules.
- Schedules of contracts in progress and contracts completed that show the financial performance of each contract and provide insight into the potential for

**Financial statements
ultimately are only as
good as the accountant
preparing them.**

future earnings from contracts in progress. This should tie in to the balance sheet.

- Schedule of general administrative expenses that reveals how well overhead expenses are controlled and managed.
- Explanatory footnotes.
- Management letter that conveys a CPA's findings, observations and recommendations about a contractor's financial business. (Not all CPAs provide management letters.)

Contractors also may need to prepare a quarterly schedule of a work in progress. This schedule should list each job by name and include:

- total contract price;

- approved change orders;
- amount billed to date;
- cost incurred to date;
- revised estimate of the cost to complete;
- estimated final gross profit; and
- anticipated completion date.

Sureties tend to favor audited financial statements because they are more likely to be materially free of misstatements compared to compilations or reviews. Auditor assurance reduces information risk in the financial statements and related accounting schedules that accompany a contractor's bond application. As information risk decreases, the surety sees less risk when issuing the bond.

Financial statements ultimately are only as good as the accountant preparing them. This is why it is important to select a CPA who is knowledgeable of construction accounting and the American Institute of Certified Public Accountants' *Audit Guide for Construction Contractors*.

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MODEL CONTRACTOR DEVELOPMENT PROGRAM EVOLVES

BY SAM CARRADINE

ix years after being introduced as a modest program of information and assistance to small and minority contractors seeking access to surety bonding, The Surety & Fidelity Association of America's (SFAA) Model Contractor Development Program (MCDP) has evolved into a sophisticated bond readiness initiative that is being implemented in locations around the country.

The MCDP has two interrelated components:

- The educational component offers 10 workshops, each of which provides contractors with information on improving their operations and increasing their bonding capacity.
- The bond readiness component consists of surety bond producers, underwriters and other professionals working one-

on-one with contractors to assemble materials necessary for a complete bond application and address any omissions and deficiencies that might deter the successful underwriting of a bond.

Since its inception, the MCDP has provided education about surety bonds; identified resources available for obtaining a first bond, such as the SBA Surety Bond Guarantee Program and similar

state and local programs; provided assistance and referrals for obtaining appropriate accounting, project management and financing expertise; and directly assisted a number of small contractors in achieving bond readiness.

This year, four MCDPs are under way in partnership with state or local jurisdictions or organizations. In Mississippi, SFAA has been working with the Office of Small and Minority Business Development, part of the Mississippi Development Authority, to develop and implement a bond guarantee and bonding assistance program for the state. The effort focuses on making Mississippi-based contractors bondable so they can take advantage of construction opportunities available as a result of Hurricane Katrina.

The pilot program began in Jackson in April, and the educational workshop component concluded with a graduation event for 16 emerging Mississippi-based contractors in June. The bond-readiness component



is ongoing, and the program was repeated in Tupelo and Gulfport in September.

Under a memorandum of understanding with the City of New Orleans, SFAA continues to work closely with city officials and the New Orleans Regional Black Chamber of Commerce to provide emerging contractors with information on access to bonding and financing, so they can participate in the Gulf Coast rebuilding effort. A formal acknowledgement of the signing and meetings with various stakeholders including representatives of the Louisiana Surety Association took place in March, and the actual program began in July.

In Chicago, the regional office of the U.S. Department of Commerce/Minority Business Development Agency set up an advisory committee with representation from key state and local governmental agencies, trade associations and business organizations—with each reaching out to contractor constituencies for participation in an MCDP that began in May. In July, more than 35 contractors completed the educational workshops component and now are involved in bond readiness activities.

As a result of the program, one Chicago contractor secured a \$2 million bond

**The MCDP has directly
assisted a number
of small contractors
in achieving
bond readiness.**

for work with the local water reclamation agency, and several other bonding applications are under review by SFAA member surety companies.

In New York City, SFAA currently is working with the chair of the New York State Minority/Women Business Enterprise (M/WBE) Advisory Committee's Bonding and Finance Task Force to develop a statewide initiative for emerging contractor bonding education and assistance based on the MCDP. Both the advisory committee and the task force are part of a broader effort by the Empire State Development Corporation, the state's

chief economic development agency, to address issues of access to capital and bonding for M/WBEs.

SFAA and Empire State signed a memorandum of understanding in early September that spells out these bonding assistance activities, including exploring the possibility of developing a bond guarantee program or other state-funded support for increasing bonding availability. An implementation plan is now being drafted.

Other places the MCDP will be implemented before the end of the year include Prince George's County, Md.; the Commonwealth of Massachusetts; Philadelphia; and Indianapolis.

For information on obtaining bid, performance and payment bonds, contact the Surety Information Office (www.sio.org), a local surety association (www.sio.org/LSAdirectory.html), a National Association of Surety Bond Producers member (www.nasbp.org/bond.cfm) or SFAA (www.surety.org).

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SIO: THE INFORMATION SOURCE

FREE MATERIALS TO HELP CONTRACTORS UNDERSTAND SURETY BONDING

BY MARC RAMSEY

The Surety Information Office (SIO) provides free resources and services to help contractors and subcontractors better understand the benefits and value of contract surety bonds to foster growth and success in the construction industry. SIO's resources—including brochures, CDs and PowerPoint presentations—offer everything a contractor needs to know, from the basics of bonding to the surety claims process and cultivating relationships with a surety bond producer and an underwriter.

Materials specifically designed for contractors and subcontractors include:

- *How to Obtain Surety Bonds*—an overview of the bonding process, from finding a producer to undergoing the prequalification process.
- *Importance of Surety Bonds in Construction*—an overview of the value and benefits of contract surety bonds.
- *Surety Companies: What They Are and How to Find Out About Them*—explains how easy it is to qualify a surety company

through readily available resources.

- *Helping Contractors Grow: Surety Bonds for New & Emerging Contractors*—information about bonding assistance and support programs, bond guarantee programs and mentor-protégé programs for new and emerging contractors.
- *An Overview of the Contract Surety Bonds Claims Process*—addresses performance bond default situations, payment bond claims and project-owner expectations.
- *Surety Bonds: A Guide for Contractors*—



narrated presentations and publications on an easy-to-use CD.

For more information, visit www.sio.org and select "Contractors/Subcontractors." To order free materials, select "Free Brochures and CDs."

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The Surety Information Office (SIO) is the information source on contract surety bonds in public and private construction. SIO offers complimentary brochures and CDs and can provide speakers, write articles and answer questions on contract surety bonds. SIO is supported by The Surety & Fidelity Association of America and the National Association of Surety Bond Producers. All materials may be accessed at www.sio.org.



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The Surety & Fidelity Association of America (SFAA) is a nonprofit corporation with members engaged in the worldwide business of suretyship. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for reporting fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state and local government agencies.



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The National Association of Surety Bond Producers (NASBP) is the association of, and resource for, surety bond producers. NASBP members are professionals who specialize in providing surety bonds for construction and other commercial purposes to companies and individuals needing the assurance offered by surety bonds. NASBP members have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet underwriting requirements for surety credit.