

Best Practices Guide



A Surety's Perspective:

Tips for a Healthy Company

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Risky Business

With unparalleled competition in recent years, less predictable profit margins and increased preferences by project owners for fixed-price contracts and design-build project delivery, construction continues to be a risky business. According to marketing research firm BizMiner (<http://www.bizminer.com/>), of the 850,029 U.S. contractors¹ operating in 2004, only 649,602 were still in business in 2006 — a 23.6² percent failure

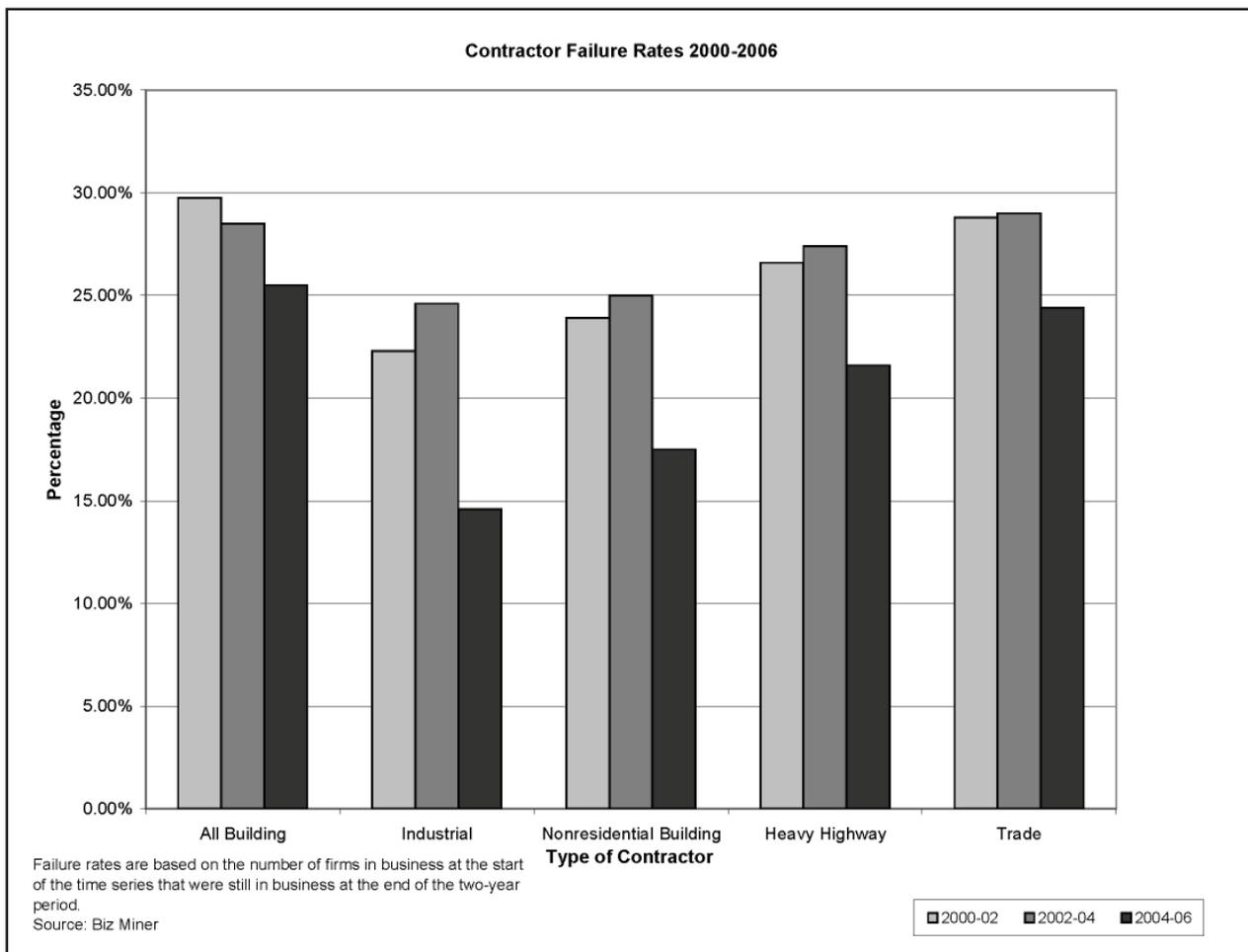
¹ Includes building (non-single-family), heavy/highway, industrial buildings/warehouses, hotel/motel, multifamily home construction and specialty trade contractors.

² May include a small number of companies that merged or changed names.

rate. Every year, thousands of contractors, whether in business for two years or 20, face bankruptcy and business failure.

Because preventing contractor default is a key component to the surety business, surety companies and surety bond producers have learned to spot business practices and conditions that can lead to contractor failure. Think of the surety's requirements as best practices that can help contractors maintain a healthy company.

ProfitCrew™, its member firms and the Surety Information Office have developed this *Best Practices Guide* to help contractors better understand risks that contractors face and how to maintain a healthy company. This guide also provides case studies illustrating how surety companies can help resolve problems and prevent default.



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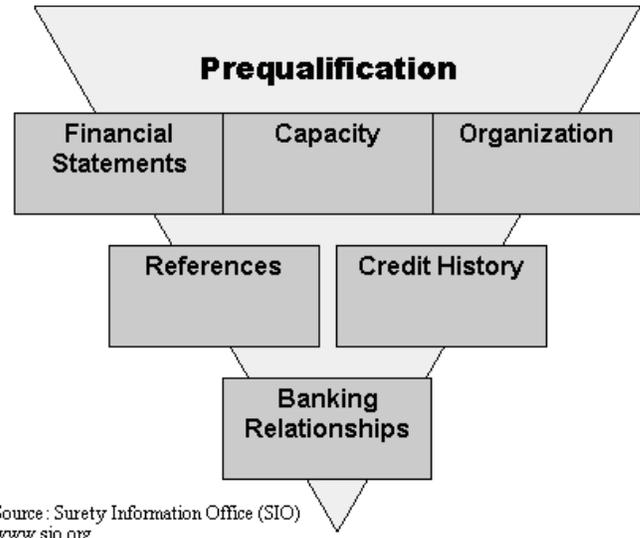
Key Characteristics of a Healthy Contractor

Before a surety company will issue a surety bond, it must be satisfied that the contractor deals fairly, performs obligations as agreed, and runs a well-managed, profitable enterprise. Prequalification is an in-depth process, which includes a complete review of financial statements, capacity to perform, organizational structure, management, trade references, credit history and banking relationships.

The most important underwriting criteria, and the most important elements in maintaining a healthy business, include the following:

- Strength of balance sheet
- Financial statement presentation prepared by a construction CPA or CA (in Canada)
- Equity
- History of successful projects, consistent earnings and profitability
- Work experience and description of past, ongoing and future work
- Amount of working capital
- Backlog
- Debt-to-equity ratio and working capital ratio
- Banking relationship and history
- Experience in geographic area
- Reputation of firm
- Comprehensive business plan, forecast, and short- and long-term strategies
- Organizational depth of leadership, accounting, estimating and project management
- Succession planning, including provisions for transference of ownership, qualification of successors, buy-sell agreements, and life insurance for owners with the company named as beneficiary
- Disclosure of joint ventures and subsidiaries

To maintain a healthy business, contractors should meet at least once a year (more frequently is preferable) with the surety underwriter and producer. Be sure to bring in your independent CPA or CA and your CFO or controller to provide a clear picture of the company's financial condition.



Source: Surety Information Office (SIO)
www.sio.org

Risks That Contractors Face

Construction is a complex business and many factors drive success or failure. Below are some recommendations from surety companies to avoid the most common risks.

Unrealistic Growth

Over-expansion – whether through significant increases in the size of individual projects, the type of work, or expanding into a new geographic area – is a leading cause of contractor failure.

Problems with accounting, management, personnel and performance can all turn “good growth” into unrealistic growth. Typically, contractors can deal with one “new” at a time – location, key management personnel, job type, size, customer, architect or key subcontractor.

Before a contractor expands its scope of business operations, it needs to have in place a strong infrastructure, including the following:

- Equipment
- Project management depth with experience and technical expertise. Rapid growth can result in outgrowing management talent, systems or processes.
- Accounting systems. Keep in mind that a business with remote sites and large sums of money requires

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- extremely effective internal accounting controls.
- Understanding of the new territory, the labor pool, subcontractors, the owner and regulations
- Estimating. An increase in the backlog of work or estimators facing a shorter lead time to prepare bids is a warning sign of larger problems. Having a good estimator who will take the time to prepare accurate estimates can make or break a project.
- Well-defined market niche and growth plan

Accounting Issues

Accounting systems are crucial for a growing contractor, and problems with those systems can lead to trouble. Before extending or increasing bonding capacity to a contractor, a surety will want to see the following:

- Adequate cost and project management systems
 - Absence of estimating or procurement problems
 - Regular job schedules
 - Adherence to proper accounting practices
 - Solid management of cash flow and overhead
 - Balance between liquidity level (cash and accounts receivable) and debt level, as well as a consistent and growing level of equity. To accomplish this
- balance, keep debt low, focus on retaining money in the business to support future growth, pay bills on time and collect receivables on time.
 - Fully secured credit lines
 - Reasonable levels of debt and retainage
 - Incremental growth (without overextending resources), consistent results and a strong financial condition
 - Sufficient working capital and net worth. Sureties look for availability and liquidity of assets, quality and quantity of net worth, and quality and quantity of working capital.
 - Manageable backlog of work with adequate project management in place
 - Accurate and current financial records, documenting change orders, disputes, claims and back charges on each project
 - Operating profitability and completed contract profitability
 - Technically competent accounting staff and a CPA or CA who specializes in the construction industry
 - Compiled, reviewed, or audited financial statements, depending on the size of the contractor and bonding requirements

Questions to Ask When Considering Out-of-State Work

Contractors who are thinking of obtaining out-of-state work should proceed with caution and ask themselves the following:

1. Is there a solid rationale for pursuing work out of state?
2. Have you formed a plan to enter that market?
3. Have you researched the local subcontractor market?
4. Do you have the proper personnel and processes in place to succeed in that market?
5. Will the balance sheet support the company if faced with unforeseen risks?
6. How fair and equitable is the new owner? Does the owner have a reputation for paying promptly? Do they use standard contract documents?
7. Why aren't local contractors doing the work? Do the locals know something that you don't?
8. What do you as an out-of-state contractor bring to the table that no one else can?
9. Can you get enough of a profit margin and contingency in your price to cover the mistakes you are going to make on your first couple of jobs?
10. Is there a connection to the new region that makes sense for you to pursue?

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Management Issues

A contractor's ultimate success or failure is largely determined by the skill of management. Healthy contractors need the following:

- Solid business management with a well-thought out game plan for where the company is going. Sureties don't want to see a company that reinvents itself every few years.
- Staff who are trained on company policy and operations
- Visionary and competent leadership. In a family business, only qualified and interested family members should be in management.
- A continuity plan in case of change in ownership or key personnel. If the owner dies, retires or sells the company, sureties want to know that successors possess financial management, marketing, business strategy and risk management skills.

The continuity plan should include the following elements:

- Life insurance coverage
- Shareholders' agreements detailing a buy-sell agreement for multiple shareholders. For example, if the purchase of the owner's stock is not properly structured, financial resources may be diverted from the company to purchase stock from the estate.
- Plan for resolving disputes and claims with subcontractors, owners and material suppliers
- Detailed business plan
- Strengths, weaknesses, opportunities and threats

Sureties also warn against the "Seven Ds of Desperation" – divorce, death, drugs, disability, disease, depression and dispute. In the case of divorce, usually half of the liquid assets disappear. The majority of construction companies are closely held family businesses, so the provisions the company has made to address succession and continuity are of extreme importance. A company with plans for transition of ownership and leadership, preservation of capital, maintenance of surety credit and continuity of the business will be better able to weather any of the "Seven Ds."

Onerous Contract Terms

Examine contracts closely for onerous terms, tight completion schedules, consequential damages, delay damages and hold-harmless obligations.

Contractors need to understand the contract (and risk variables such as financing, schedule and scope) and look for effective and equitable contract language that spells out the responsibilities of the owner, contractor and design professionals. Furthermore, the contract should define circumstances constituting default. Contractors should adhere to contract requirements, such as scheduling, and comply with notice requirements. If the contract language is onerous, you're better off declining the job.

Unsuitable Clients

Contractors need to be selective about who they work for. A difficult owner is a frequent reason cited for contractor failure. An owner who doesn't have adequate financing may not pay on time, or at all, creating liquidity problems. Disputes and unsigned change orders leave the contractor with little leverage and tie up cash flow, increasing susceptibility to bankruptcy. Contractors who think they can win at these games often set themselves up to fail.

Think long and hard before accepting a job that is outside your area of expertise. The contractors that are most profitable are those that specialize in just a few areas. If you have expertise in building schools, you may not succeed at a hotel project.

Also, determine your minimum profit margin, and say no to projects that don't meet that minimum. You may be better off adjusting overhead rather than accepting a job just to keep employees busy.

Other Factors

Even the best contractors can be affected by uncontrollable work environment issues such as inclement weather, poor site conditions, a sudden economic downturn or high inflation. Contractors with good cash flow and a solid line of bank credit are more likely to survive unforeseen events.

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How the Surety Can Help You Avoid Default

A surety company does more than prequalify contractors. It also helps nurture and foster profitability and success.

Should the contractor experience difficulties on a project, the surety company may elect to assist the contractor to head off default.

Generally, the surety does not involve itself in the daily occurrences of a project, and it expects the contractor and owner to be able to resolve most disputes. Sureties will insist that they cannot assume responsibility for performance unless the contractor is defaulted, but that does not mean they cannot and should not investigate problems and consider alternatives prior to termination. After all, disagreements can escalate and become breaches of the contract, which can lead to default.

Early warning and cooperation are essential. Often, contractors wait too long to let their surety know a problem exists, resulting in few viable solutions. Contractors with an open line of communication with the surety producer and underwriter can use that relationship to their advantage. The surety can, in many cases, provide guidance, resources and a fresh perspective on the problem.

Owners, contractors and sureties all benefit from a process where project managers promptly communicate emerging problems between the parties and jointly develop efficient, workable solutions.

This section provides specific examples of ways sureties have worked with contractors to ensure completion of a project by providing mediation, working capital, bank credit and technical assistance.

Mediation

When problems occur on a construction project, it's likely that the relationship between the owner and contractor is strained.

Early dispute resolution procedures can prevent disagreements from bringing a project to a halt, and

sureties have experience working with contractors and owners to resolve disputes.

Case Study: *Keeping the Peace*

When an owner's project manager didn't get along with the contractor on a \$532 million remodeling project of an historic lodge, the fireworks began.

According to the contractor, there were problems from the start, which centered on the owner's demanding and unreasonable project manager. Only two months into the job, the contractor asked the surety company for help and advice after the owner threatened to declare the contractor in default. The surety company spoke with the contractor, then arranged a meeting at the job site with the owner and contractor. The surety company representative witnessed three hours of arguing and finger-pointing.

Realizing the situation was out of hand and work would be delayed without resolution of the problems, the surety company's claims representative talked with the owner and contractor to get an understanding of both sides of the issue. A few days later, the claims representative went to the job site and spoke with the contractor's crew and subcontractors, the project manager and the owner.

The surety company objectively addressed the contractor's deficiencies in performance and offered suggestions for improvements. The surety convinced the owner to remove the project manager from the job and make timely payments to the contractor. The owner and contractor agreed to follow through on the surety company's recommendations. They both acknowledged that things were much improved and the job was progressing well. As a result, no performance or payment claims were filed, and the contract was completed as scheduled.

The contractor appreciated the surety company's involvement, saying "It appeared that our company faced termination, but due to the immediate response by the [Surety Company] Loss Control Team, we were able to interface with the owner and resolve issues before the project went completely bad and any legal action developed."

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Working Capital

When unexpected losses threaten your company's viability, early communication with the surety is essential. Surety companies may provide financial assistance directly to a bonded contractor, which enables the contractor to continue its work program, pay subcontractors and suppliers, and keep the project moving forward. This assistance may be provided at the contractor's request without the involvement of the project owner and may occur without formal declaration of default.

Case Study: *Early Warning Prevents Default*

A \$43 million bridge contract was over budget, and the contractor had given up any hope of a profit. With the job 95 percent complete, the bridge pilings began exploding – along with the contractor's hopes of completing the project.

When the state highway department stopped all payments to the contractor, including a large earned sum, the surety was called in to investigate. The surety advanced \$4.5 million to the contractor and arranged analysis of why the pilings exploded in order to correct the problem. Because the surety was notified in a timely manner, it was able to prevent contractor default. This assistance:

- Kept the contractor from bankruptcy
- Completed the bridge promptly for public use
- Assured payments to subcontractors who were on the verge of bankruptcy themselves

Line of Credit

In construction, circumstances can change rapidly, resulting in a drain on capital and bank credit. When the surety becomes aware of a contractor's financial difficulties, it may guarantee a line of bank credit. This assures a steady flow of materials to the work site and payments to subcontractors.

Case Study: *Between a Rock and a Hard Place*

A \$26.5 million contract with the U.S. Army Corps of Engineers called for the construction of a port facility for another nation as part of a foreign aid package. The contractor was required to excavate rock and then construct a pier and protective area with this rock.

When the area didn't yield the right type of rock, the Corps told the contractor to find it elsewhere. This proved to be a costly and fruitless search. The Corps then agreed to accept rock of less density and weight. However, this increased the contractor's cost so much that all working capital and bank credit was soon exhausted. On the verge of default, the contractor sought financial assistance from the co-sureties.

The co-sureties paid off loans and arranged a guaranteed line of credit for the contractor, who borrowed \$19 million to complete the contract. The total cost exceeded \$53 million, but with continued bonding and new profitable work, the contractor survived and continued in business.

Case Study: *Fraud Leaves Contractor Short*

Employee embezzlement left a contractor with little capital, despite a healthy workload of more than \$56.7 million. Banks stopped credit and called in their loans. The contractor faced default on several large federal contracts in various stages of completion.

The surety spent \$11.8 million to pay outstanding bills, assisted the contractor with guaranteed bank loans, and avoided default on all jobs.

Case Study: *Non-Bonded Jobs Pose Threat*

A general building contractor suffered serious losses on non-bonded shopping center contracts when the owners became insolvent. This impaired the contractor's working capital and bank credit so drastically that he was on the verge of defaulting on several bonded contracts. The contractor contacted the surety company, which arranged a \$2 million guaranteed loan. The contractor completed all work, and the owners were never fully aware of the contractor's financial dilemma.

Technical Assistance

Some jobs can take on a life of their own, outstripping a contractor's capabilities and bench strength. Many sureties employ professional engineers, accountants and other technical staff or advisors who can help a contractor succeed.

Case Study: *Surety Provides Experienced Personnel*

A construction firm began work on an \$8 million prison

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project. Initially, work proceeded on schedule. But soon, the contractor needed clarifications from the owner's project management team on specifications and drawings.

Progress slowed as the owner took increasingly longer periods to respond to the contractor's Requests for Information (RFI) and change order requests. Tensions mounted, the work slowed to a grinding halt, and the project quickly fell behind schedule. Several months later, the owner's project management team still had not addressed many of the construction issues critical to project completion.

As the project slowed, so did payment to the contractor. To compound the contractor's cash flow problems, it was unable to collect a large receivable on an unrelated non-bonded job. The contractor turned to the surety for assistance with completing the bonded prison job.

The surety dispatched its claims team to the job site. After conducting its inspection of the construction site and financial review of the contractor, they resolved immediate cash problems by advancing \$500,000 to pay subcontractors and suppliers. They also appointed an on-site construction representative who monitored the contractor's work and helped the contractor and the owner's project management team resolve the outstanding RFI and change orders.

Finally, the surety supplemented the contractor's project management team with six additional engineers and job superintendents. This enhanced the contractor's coordination of the work, and the project was completed successfully.

Case Study: Contractor Calls for Help

Life was good for a large sewer, water and tunneling contractor. The company had completed \$34 million in projects with an aggregate workload of \$68 million and had bid 600 jobs in the last two years. Then the company's bank line of credit dried up, and more problems followed. Two projects had unusually high start-up costs. Labor problems on another project resulted in two years of substantial losses. More than \$1.7 million in retainage was tied up in litigation for two years, and the contractor expected an additional \$2.7 million in retainage to be frozen as well. The surety company took the following steps:

Know When to Call a Surety

Contractors often don't want to inform the surety company of problems due to fear of losing bonding capacity. But sureties are aware of the myriad risks that contractors face and are more willing to extend bonding capacity to contractors that keep them in the loop. Contractors that quickly identify problems and seek solutions to get projects back on track are more likely to avoid default.

The following red flags may indicate it's time to call in the surety for help:

- | An unexpected change in management, such as due to a death or illness
- | Unusually high employee turnover
- | Employee fraud
- | Working capital deficit on bonded jobs or non-bonded jobs that could threaten bonded jobs
- | Higher-than-expected costs
- | Subcontractor financial problems or performance defects
- | Unforeseen difficulties such as severe weather, lack of skilled labor or materials
- | A dispute or breakdown of communication with the owner
- | Shortage of bank credit
- | Slow payment or lack of payment

Developing and maintaining a lasting surety relationship is essential, especially in times of economic uncertainty. Along with a construction-oriented CPA or CA, banker and a knowledgeable lawyer, your surety producer and underwriter can help you keep your company on track and out of default.

- Analyzed the bids on a \$30.8 million project
- Investigated the status of retainage litigation
- Appraised the contractor's equipment and recommended that some equipment be sold
- Analyzed the contractor's organization from field supervisors to top management

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- Developed a cash flow projection based on anticipated completion of all work in progress
- Worked with the banks to develop a payment schedule for equipment loans
- Arranged bank credit for additional working capital up to \$4.5 million (the contractor eventually used \$3.3 million)

The contractor got back on track before these problems affected the project, which protected the contractor's reputation and standing in the industry. Seventy-five employees and more than 400 material suppliers and subcontractors were paid. Although the contractor's retainage remained frozen, the surety's assistance was discontinued three months ahead of the projected date.

What to Expect in the Surety Claims Process

In the unfortunate event that the owner declares a contractor in default, the surety must investigate the claim, analyze all options, and choose a course of action.

First, it must investigate the claim in order to protect the contractor's legal recourse in the event of an improper declaration of default. At the same time, the surety has obligations to the owner.

Default should be clearly defined in the contract. Once notified of a default, the surety company independently investigates notices of disputes or claims and provides its assessment to the obligee (the party protected by the bond). The investigation must be impartial to meet state standards as well as the surety's own company service requirements, so claims investigators are expected to be thorough and deliberate, an approach that can be time-consuming.

If the investigation reveals that the contractor is not in default, the surety company is not obligated to perform.

Sometimes a default is crystal clear. The bonded contractor is in bankruptcy and has admitted that it cannot fulfill its obligations. It may have agreed that the obligee has not contributed to the default. In such a circumstance, the surety should be able to act relatively quickly.

If the surety's investigation finds that the contractor has defaulted on the project under the performance bond, the surety may take one of the following actions, depending on the bond form and the specific facts of the case:

- **Take over the contract.** The surety formally takes over the project, signs a "takeover agreement" with the obligee, and becomes the principal. The surety may offer the job for rebid and hire a completion contractor, or subcontract the remaining work.
- **Tender a completing contractor to the obligee.** The surety chooses the completion contractor, negotiates the price and terms of the contract, and "tenders" it to the obligee. The surety pays the obligee the difference in price to complete the remaining work upon job completion.
- **Retain the original contractor.** The surety provides financial assistance, funds control, legal counsel, engineering or construction consultants, or construction-oriented accountants.
- **Reimburse the owner.** The surety pays cost of completion, up to the penal sum of the bond. Project completion then becomes the obligee's responsibility.

Early communication with the surety improves the claims process. A surety's ability to limit the impact of a default is directly related to whether or not the obligee has kept the surety informed of the status of the project, how quickly the obligee provides needed information when a default is declared, and the level of cooperation of both the principal and the obligee.

The Associated General Contractors of America (AGC) has published an overview of the surety bond claims process, which provides useful information on what to expect in a claims situation. This booklet is available from the Surety Information Office (<http://sio.org> or 202-686-7463) at no charge.

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Sources of Surety Information

Information about surety companies can be obtained from the Surety Information Office (<http://sio.org>) and The Surety & Fidelity Association of America (SFAA), (<http://surety.org>). SFAA represents the majority of companies that write surety and fidelity bonds in the United States.

Other sources of information about surety companies include:

- State insurance departments (http://naic.org/state_web_map.htm), which license companies that write surety bonds
- U.S. Department of the Treasury (<http://fms.treas.gov/c570/index.html>), which issues a certificate of authority to surety companies that are qualified to write surety bonds on federal government projects. This is called the "T-list."
- Ratings organizations, such as A.M. Best Company (<http://ambest.com>), Dun & Bradstreet (www.dnb.com/us), Fitch Ratings (<http://fitchratings.com>), Moody's Investors Service (<http://moody.com>), Standard & Poor's (<http://standardandpoors.com/>) and Weiss Ratings Inc. (<http://weissratings.com>)
- Surety bond producers (for a listing, see <http://nasbp.org>), who work in agencies that specialize in surety bonds or in insurance agencies that have a sub-specialty in surety bonds. The producer maintains a business relationship with several surety companies, which enables the producer to match a contractor with an appropriate surety company.

Source: *Surety Companies: What They Are & How to Find Out About Them* (SIO)

Checklist: How to Stay Healthy

- | Yes | No | |
|--------------------------|--------------------------|---|
| <input type="checkbox"/> | <input type="checkbox"/> | We have a secured line of bank credit sufficient to fund operations for several months. |
| <input type="checkbox"/> | <input type="checkbox"/> | We bond subcontractors who represent a key trade or a significant portion of work. |
| <input type="checkbox"/> | <input type="checkbox"/> | We qualify our surety by checking the A.M. Best rating. |
| <input type="checkbox"/> | <input type="checkbox"/> | For federal projects, we check that the surety is on the "T-list." |
| <input type="checkbox"/> | <input type="checkbox"/> | We qualify owners to ensure they have sufficient financing. |
| <input type="checkbox"/> | <input type="checkbox"/> | We know our ideal profit margin and don't accept projects that don't meet that minimum. |
| <input type="checkbox"/> | <input type="checkbox"/> | We prepare quarterly job schedules. |
| <input type="checkbox"/> | <input type="checkbox"/> | A CPA or CA with significant experience serving construction companies prepares our financial statements. |
| <input type="checkbox"/> | <input type="checkbox"/> | We meet at least annually with our surety underwriter and producer. |
| <input type="checkbox"/> | <input type="checkbox"/> | Our CPA or CA is involved in the annual meeting with our surety representatives. |
| <input type="checkbox"/> | <input type="checkbox"/> | We contact our surety when we experience significant financial difficulties on bonded or major non-bonded projects. |
| <input type="checkbox"/> | <input type="checkbox"/> | We undertake only one "new" situation at a time (location, key management personnel, job type, job size, customer, architect, key subcontractor). |
| <input type="checkbox"/> | <input type="checkbox"/> | Our accounting systems provide sufficient information to make accurate estimating and cash flow management decisions. |
| <input type="checkbox"/> | <input type="checkbox"/> | We have a strategic plan. |
| <input type="checkbox"/> | <input type="checkbox"/> | Our staff are trained on company policy and operations. |
| <input type="checkbox"/> | <input type="checkbox"/> | We have a succession plan for owners and key management personnel. |
| <input type="checkbox"/> | <input type="checkbox"/> | We ensure contract language is equitable and spells out the responsibilities of the owner, contractor and design professionals. |
| <input type="checkbox"/> | <input type="checkbox"/> | We have enough working capital to cover "rainy-day" circumstances. |

Before accepting out-of-state work:

- | | | |
|--------------------------|--------------------------|--|
| <input type="checkbox"/> | <input type="checkbox"/> | We have a solid rationale for entering the market. |
| <input type="checkbox"/> | <input type="checkbox"/> | We have experienced project managers with the skill set required for the job. |
| <input type="checkbox"/> | <input type="checkbox"/> | We research and form a plan to enter and expand in the market. |
| <input type="checkbox"/> | <input type="checkbox"/> | We research the local subcontractor market. |
| <input type="checkbox"/> | <input type="checkbox"/> | We ensure the profit margin will be adequate to cover mistakes that are a natural part of expansion. |

NOTES



The construction business is like no other, with cycles and risks all its own. It's even one-of-a-kind when it comes to accounting, taxes, key performance indicators and profit drivers. That's why general-practice accounting firms don't have a thorough understanding of your toughest challenges - or your best opportunities.

ProfitCrew™ is a dynamic group of accounting firms who know construction and real estate. We have a deep level of industry-specific expertise and are dedicated to solving your real-life accounting, tax and business problems.

Your ProfitCrew™ firm can help you:

- increase cash flow
- grow your business
- analyze working capital
- control costs
- save on taxes
- benchmark against your competitors
- and much more!

For more information, visit <http://profitcrew.com>.



The Surety Information Office (SIO) is a not-for-profit organization representing the contract surety bond industry. SIO is supported by the Surety & Fidelity Association of America (SFAA) and the National Association of Surety Bond Producers (NASBP).

SIO distributes educational materials on the benefits of contract surety bonds in public and private construction. Free materials include brochures, CDs, and PowerPoint presentations. SIO can also provide surety professionals to speak to your organization, articles for your company newsletter, and answers to questions on contract surety bonds.

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