



## FINANCIAL STATEMENTS AND THEIR IMPACT ON BONDING



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**Y**ou may have heard of the “Three Cs” of surety underwriting; capacity, character, and capital. Capacity is easily quantifiable, either the personnel and equipment are available to take on a specified project, or they are not. The character of your company will be determined over time through communication with your surety bonding agent and the actions you take. However, capital is the great unknown. Therefore, the surety underwriter and producer depend on timely and accurate financial statements prepared by a certified public accountant.

These financial statements among other factors are used by the underwriter to determine the amount of surety credit that will be extended to a company. A contractor’s aggregate bond limit is largely determined by the company’s working capital, net worth and leverage positions as reflected in their financial statement, especially its fiscal year-end financial statement. In conjunction with the year-end statement, an interim statement, typically six months from the year-end is used to establish your bonding program.

The ‘aggregate’ limit is the level that a surety feels comfortable supporting a contractor for all its work. This includes both bonded and unbonded work. It is not the accumulation of the contract prices, but rather the evaluation of the costs that need to be incurred from the current date to complete the contracts in progress. Since the aggregate level is determined by a company’s financial statement, it is critical that these financial statements look as good as they can.

Sureties, along with banks and other institutions use ratios as a gauge to understanding a construction company’s financial strength. A financial measure of considerable significance to contractors is the ratio of net revenues to working capital, or working capital turnover. Working capital is the difference between current assets and current liabilities. Working capital turnover indicates how efficiently the company is using this working capital. A contractor should learn quickly that working capital buys bond credit, or  $WC=BC$ . And they should also realize that in order to increase their bonding capacity they have to grow their company and that means making a profit and avoiding debt. It also means paying some taxes and this is where a CPA who understands bonding comes in. Contractors who make little or no profit to avoid taxes never grow their company and therefore their bond capacity does not increase.

The leverage position of a company refers to the extent to which the company is financed by debt. Leverage ratios are used to tell creditors how well their debt is secured and is often called “credit risk.” Creditors who lend to contractors who have acceptable leverage ratios have less

credit risk and are less likely to experience losses when the economy goes into a downturn. Leverage is calculated using balance sheet ratios to determine the extent to which borrowed funds have been used to finance the construction company. The risk of debt is determined by ratios applied to the income statement for determining the extent to which profits can be used to pay not only principal but also interest. Contractors who have too much leverage run the risk of failure by not being able to repay its debt and therefore, their bonding capacity may be limited.

Typically, a contractor must provide a schedule of work in progress and completed projects with their financial statements. The underwriter reviews these schedules for increases in contract prices, estimated costs to complete a project and over and under-billings. Since premiums are calculated based on contract price, the underwriter will look for bonded projects that require additional premiums to be billed. They will also compare the report to prior period reports for changes in gross profit percentages and the progress of each job.

When completing the work in progress schedule, it is better to remain conservative. If your completed projects are finishing with a lower gross profit than projected on previous schedules, you will have explaining to do to the surety. However, if the gross profit percentage increased over your estimate, the bonding company will have a positive reaction. Additionally, "Costs in Excess of Billings" will be scrutinized as projects that are under-billed may signify lower actual gross profit levels than indicated on the schedule. Finally, "Billings in Excess of Costs" will be reviewed to see if your liquidity level remains strong since this is treated as a liability.

In addition to reviewing the "numbers" subsequent event footnotes may make it possible to get credit on fiscal year end financial statements. For example, if you need to inject additional capital into your company to achieve your bonding goals, you can still do this in the new year, and have the CPA disclose the transaction in the footnotes to the financial statement. This is important to know since this statement will largely determine you bonding program.

Bonding companies are not as willing as in the past to base their decisions on a "feel" for an account and it may seem the surety is only concerned with the numbers on paper. The reality is that those numbers reflect more than the bottom line. They reflect character, management style, and commitment to foster a relationship with the surety. Bonding companies want to see a sound financial statement and a well-run business that is willing to put money back into the company for a long-term commitment. In addition, the bonding industry has been affected by mergers and reorganizations. Every time companies merge there is a period of uncertainty, and the underwriters tend to be very conservative until they have a higher comfort level in the new organization. A lack of financial diligence is one of the biggest causes of surety credit problems.

Contractors must realize that surety companies are not looking for them to build a project; they are looking for sound business people who run construction companies. Fulfilling contractual obligations is important but you must also be able to generate income from those projects. The underwriter is not going to increase surety credit when your projects are just breaking even.



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They want to know that your company can continue to grow and generate revenue from the projects undertaken.

As one of the leading accounting and consulting firms for the construction industry, Cowan, Guteski & Co., P.A. understands how important your financial statements are to securing the financing and/or surety bonds you require to keep your business operating and growing. Contact Bill McNamara, CPA - Director of the Construction Services Group at 732-349-6880 extension 116 or [bmcnamara@cowanguteski.com](mailto:bmcnamara@cowanguteski.com) for more information on obtaining surety bonding.

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