September 29, 2010

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

ATTN: Technical Director - File Reference No. 1820-100

CNA Surety Corporation is the fourth largest writer of surety bonds in the United States and the largest publicly traded surety company in the country. Through our principal subsidiary, Western Surety, CNA Surety provides surety bonds in all 50 states through a combined network of approximately 37,000 independent insurance agents. CNA Surety has a client base of over 5000 contractor clients where we request financial statements. We have roughly another 20,000 clients where we also gather some level of financial information which may also include formal financial statements. This client base represents a good cross section of the entire U.S. construction market as we provide surety bonds to all segments of the construction industry including trade contractors, general contractor, heavy highway contractors, engineering firms etc. Our contractor clients have annual revenues from less than $5mm to over $510 billion.

Suretyship is a specialized line of insurance where one party guarantees the performance of an obligation by another party. Generally, there are three parties to the agreement, the principal, the obligee and the surety. The principal is the party that undertakes an obligation to a second party, the obligee. The surety guarantees the obligee that the principal will perform the obligations. The surety bond is a written agreement that normally provides for completion of the particular performance obligation should the principal fail to perform as promised.

While there are many types of surety bonds in the United States, the largest percentage of surety bonds are issued on behalf of construction clients. Surety bonds are required on nearly all public construction contracts and good percentage of private construction projects. Surety companies collected over $3.2 billion in contract surety premiums in 2009 which represents well over $300 billion in bonded construction performance obligations.

In suretyship, surety professionals view their underwriting as a form of credit so the emphasis is on prequalification and selection. In very broad terms, the surety will focus on the capacity, character and the capital of the principal applying for the bond. In assessing the capital part of this process, the surety company relies heavily on the financial statements issued by or on behalf of these contractor clients. As such, CNA Surety and the industry have a very vested interest in the recent exposure draft regarding Revenue from Contracts with Customers.

One of the more critical aspects of our underwriting is the review of the open and completed job schedules. These schedules allow us to review job progress as it relates to revenues, profitability, costs and under and overbillings. For years, the industry has relied on SOP 81-1 for guidance on acceptable methods of recognizing revenue on construction contracts and suggested presentations for accompanying work on hand schedules. While the guidance does allow various methods of recognizing revenue, the industry has seemed to gravitate towards a percentage of completion method as measured on a cost to cost basis. While we are sure there are arguments for and against this method, from our vantage point this has become the most widely accepted manner of recognizing revenue in the construction industry.
With a client base of over 25,000 contractor clients, it is extremely important we are presented financial statements that have some degree of consistency and comparability from one client to another. It is important that we are able to compare and contrast the performance of one contractor against another. At a higher level, or on a portfolio basis, it becomes even more important as we model the credit strength of our overall book of business. We, and many in the industry, have built credit models that incorporate key financial data into the models. As with any model, if the inputs are not consistent and comparable, the models are worthless. Credit modeling of the entire portfolio of accounts is instrumental in tracking the quality of the book of business and is viewed very favorably by our rating agencies, creditors, Board of Directors and reinsurance partners.

The exposure draft on Revenue Recognition, in its existing state, opens the door for broad interpretations by certified public accountants throughout the construction industry. We rely upon CPA reviewed or audited financial statements. The financial statements we receive are from CPA’s that represent a good cross section of all Certified Public Accountants providing services to the construction industry from the one person firm, local or regional accounting firms to the largest national accounting firms. With this diverse client base by type of contractor, size of contractor and financial statement preparers, it is critical that the most objective rules based guidance be provided to the financial statement preparer to result in consistent comparable financial statements from which we can base our credit decision. Significant lack of consistency will cause difficulty in our underwriting of particular risks and overall modeling of the portfolio. Without consistent, reliable management tools to run our business, we could face higher reinsurance and lending costs which in turn could result in higher bond premiums in the industry.

Additionally, we are concerned with potential unintended consequences from this exposure draft. The evaluation of financial statements is a cornerstone of the surety underwriting process. We rely upon CPA reviewed or audited financial statements. Under the exposure draft subjectivity is substantially increased in the areas of determining performance obligations, estimating the contract price using probability weighting, and allocating the transaction price to identified performance obligations. We anticipate GAAP financial reporting costs will increase for our contractors and fees charged by independent CPA firms will increase. End result is that due to the increased cost we may see a significant shift from audited statements to reviewed statements. More concerning, is that we may see more qualified opinions. Increased cost with the unintended consequence of decreasing quality of financial reporting. This would increase our overall risk and may reduce the amount of surety credit available to the contractor.

The easiest solution would be to exempt the construction industry from the Board’s new proposed approach. Barring that possibility, we would strongly encourage somehow drawing in as many of the provisions of the SOP 81-1 as possible. The surety industry is arguably the largest user of financial statements for the construction industry thus we believe every effort should be made to understand and incorporate the user’s needs.

Thank you for your consideration.

Sincerely,

John Welch, CPA
President & CEO