How to Obtain Surety Bonds

An Introduction to Contract Surety Bonding for Contractors

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Federal, state, and local governments require surety bonds in order to manage risk on construction projects and protect taxpayer dollars. However, surety bonds are not limited to public construction. Many private project owners stipulate bonding requirements on their projects, and prime contractors may require subcontractors to obtain bonds.

In today's competitive construction environment, a contractor's ability to obtain surety bonds has a significant effect on that contractor's ability to acquire work.

What is a Surety Bond?

A surety bond is a three-party agreement whereby the surety assures the project owner (obligee) that the contractor (principal) will perform a contract in accordance with the contract documents. When a contractor requires its subcontractors to obtain bonds, the contractor is the obligee and the subcontractor is the principal.

Most surety companies are subsidiaries or divisions of insurance companies, and both surety bonds and traditional insurance policies are risk transfer mechanisms regulated by state insurance departments. However, traditional insurance is designed to compensate the insured against unforeseen adverse events. The policy premium is actuarially determined based on aggregate premiums earned versus expected losses. Surety companies operate on a different business model. Surety is designed to prevent a loss. The surety prequalifies the contractor based on financial strength and construction expertise. The bond premium is an actuarially based fee that takes into consideration the potential for claims payments and also serves as a fee for the surety's in-depth prequalification service.

How to Begin

Because most surety companies distribute surety bonds through the agency system, the first step is to contact a professional agent or broker, also known as a surety bond producer, who specializes in contract surety. A professional surety bond producer guides the contractor through the bonding process, helps establish and foster a business relationship with a surety company, and assists in managing the contractor's surety capacity.

A professional surety bond producer can offer sound business advice and technical expertise, such as contract document review. The producer can introduce the contractor to other professionals or consultants when appropriate.

After meeting with the contractor and gaining an understanding of the firm's business and needs, the producer tailors the contractor's submission for the specific requirements of the surety company. The producer then submits the account to a surety company best matched to the contractor's profile and needs. It is important to recognize that all surety companies are not the same. For example, some specialize in large contractors, some in middle markets, and others in emerging contractors. If necessary, the producer can guide the contractor through a formal presentation and meeting with the surety company. The producer is an essential link between the contractor and the surety company and should maintain communications with both.

Three Basic Types of Contract Surety Bonds

- The **bid bond** assures that the bid is submitted in good faith and that the contractor will enter into the contract at the price bid and provide the required performance and payment bonds.
- The **performance bond** assures the owner that, in the surety's opinion, the contractor is capable and qualified to perform the contract and protects the owner from financial loss should the contractor fail to meet the terms and conditions of the contract. A qualified, bonded contractor is more likely to complete the project according to the contract provisions. Default is not in the best interest of the surety, contractor, or owner. When problems occur, the surety may offer financial, technical, or managerial assistance to the contractor in order to prevent default.
- The **payment bond** assures that the contractor will pay specified subcontractors, laborers, and materials suppliers associated with the project.

To find a producer who specializes in contract surety bonding, contact the National Association of Surety Bond Producers (NASBP) at 202-686-3700 or www.nasbp.org. NASBP members adhere to a code of professional standards.

Verify Your Bond

Several resources are available to ensure your bond is from a legitimate source. You may contact your state's insurance department to verify that the surety is a legitimate company, licensed to issue surety bonds in that state; you may review the U.S. Department of Treasury's List of Approved Sureties Department Circular 570 (for federal projects); and you also may verify the strength of the surety company through a private company such as A.M. Best, which issues financial-strength ratings that measure the company's ability to pay claims. Furthermore, The Surety & Fidelity Association of America has a Bond Obligee Guide, designed to serve those that want to verify the authenticity of the surety bonds presented to them. SFAA also provides a Bond Authenticity Model Inquiry Form on its website. You should undertake these steps to verify your bond protection early, preferably before signing the contract.

Surety Company Underwriter

Once the surety bond producer collects all the necessary information, he or she submits it to a surety company underwriter. The underwriter takes an in-depth look at the contractor's entire business operations and must be satisfied that the contractor is capable of completing the project.

The underwriter may request a meeting with the contractor to form his or her opinion and obtain additional information. For example, the underwriter may want more information on the single job size and aggregate workload for all projects, bonded or not, in the contractor's current and projected work program. If the contractor wants to bid on a larger-than-usual project, the underwriter will want to know whether it is prudent for the contractor to undertake it from a risk/reward standpoint, how it fits into the current work program, how the project will be financed, and a projection of the return.

Although it may seem as if surety underwriters focus on the contractor's finances and financial structure, they are also interested in other elements of the contractor's business. The contractor's organization, track record, and approach to a job, once established, are not generally questioned with frequency if the contractor's results are consistent. However, should there be significant changes in ownership or key personnel or the contractor decides to move into a different type of construction or geographic area, this information should be shared with the surety along with any other changes in the contractor's capabilities or the way the contractor conducts business.

The contractor's financial situation fluctuates from day to day, from job to job, and consequently is the area that is subject to the greatest scrutiny. When applying for bonds, the contractor must be aware that, once the surety is satisfied as to the technical ability to perform, it will then review the financial results of performance and translate that into a decision on the firm's present and future ability to pay bills, finance additional undertakings, and accept or mitigate risk. The numbers are the scorecard that tells all parties how well the contractor is performing.

Qualities of a Professional Surety Bond Producer

- Is well respected and has a reputation for integrity in the construction industry;
- Demonstrates a personal interest in the contractor's success;
- Has a track record of building solid relationships with surety underwriters;
- Possesses an understanding of the construction industry;
- Has knowledge of accounting and finance, especially construction accounting procedures;
- Has knowledge of construction contracts, subcontracts, and related contract law;
- Is aware of local, regional, and national construction markets;
- Is experienced in strategic planning and management practices that promote successful contracting; and
- Is actively involved in and supports local and national construction and surety industry associations.

Prequalification Process

Each surety company has its own underwriting standards and requirements, but there are shared fundamentals common to the underwriting of most surety companies. Before a surety underwrites a bond, the contractor typically undergoes a careful, rigorous, and thorough process, often referred to as prequalification. The prequalification process takes time as the producer collects information, answers questions the surety underwriter may have, and assists in verifying information. The surety must be satisfied that a contractor has the ability to meet current and future obligations, has a good reputation, has experience meeting the requirements of the projects to be undertaken, and has (or can readily obtain) the equipment necessary to perform the work. The surety also looks for contractors who run a well-managed, profitable enterprise, keep promises, deal fairly, and perform obligations in a timely manner.

Prequalification Checklist

Here is what a contractor may need to provide:

- An **organization chart** of key employees and their responsibilities;
- Detailed **resumés** of key employees;
- A **business plan** outlining the type and size of work sought, prospects for such work, the geographic area in which the company operates, and growth and profit objectives;
- Current work in progress as well as a history of the **largest completed jobs**, including the name and address of the owner, the contract price, date completed, and the gross profit earned;
- A **continuity or completion plan** outlining how the business will continue in the event of the owner's death or disablement (the surety may suggest that the plan include life insurance on key owners with the construction company named as beneficiary);

- Evidence of a bank **line of credit** to augment working capital and to handle temporary cash flow deficits or strains. Sureties will look at the security for the credit and the extent to which bank loans are used and the amount and terms of their repayment. Sureties generally look for an unsecured line of credit or a line of credit obtained through the long-term financing of equipment or real estate; and
- **Letters of recommendation** or references from subcontractors, owners, architects, and engineers on completed projects.

Financial Statements

Depending on how long the contractor has been in business, the surety will request fiscal year-end statements for at least the past three years and may require a financial statement audited by a certified public accountant (CPA). Financial statements typically include the following:

- **Accountant's opinion page**—discloses whether the statements were prepared according to audit, review, or compilation standards.
- **Balance sheet**—shows the assets, liabilities, and net worth of the business as of the date of the statement. This helps the surety company evaluate the working capital and overall financial condition of the company.
- **Income statement**—measures how well the business performed. The surety analyzes each item, including gross profit on contracts, operating profit, and net profit before and after tax provisions.
- **Statement of cash flow**—discloses the cash movements from operating, investing, and financing activities.
- Accounts receivable and payable schedules—should reflect aging.
- **Schedules of contracts in progress and contracts completed**—show the financial performance of each contract and provide insight into the potential for future earnings from contracts in progress. This should tie into the balance sheet.
- **Schedule of general and administrative expenses**—may reveal how well overhead expenses are controlled and managed.
- **Explanatory footnotes**—qualifications made by the accountant.
- **Management letter**—conveys the CPA's findings, observations, and recommendations about the contractor's business. Not all CPAs provide management letters.

Accounting Methods

Complete and accurate accounting systems are extremely important to surety companies. The American Institute of Certified Public Accountants' (AICPA) *Audit Guide for Construction Contractors* recommends the percentage-of-completion accounting method, which is also preferred by most sureties. The percentage-of-completion method best represents a contractor's financial condition and most accurately measures results of work performed during the accounting period. The percentage of contract values recognized as revenue typically is done on a cost-to-cost percentage-of-completion method.

Depending on the time elapsed since the last fiscal year-end statement, the surety may ask for an interim financial statement every three or six months to show how the current year is progressing.

Contractors also need to prepare a quarterly schedule of 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.

The format of this exhibit and the amount of information required varies among surety companies and almost always is required in connection with the full CPA reports.

Quality of Financial Statements

Financial statements are only as good as the accountant preparing them. That is why it is important to select a CPA who is knowledgeable about construction accounting and the American Institute of Certified Public Accountants' Audit Guide for Construction Contractors. Sureties prefer, and at certain levels require, audited fiscal year-end statements, but there are occasions when a surety may accept a review or compilation statement.

An audit verifies relevant items in the financial statement with internal and external investigations of their accuracy. The accountant certifies that the financial statement is presented in accordance with generally accepted accounting principles.

A review statement, which does not require the outside verification present in an audit, consists principally of a thorough review of the contractor's financial records and the application of certain analytical procedures to the financial data. Although narrower in scope than a full audit, the review does provide some limited assurance about the financial statements.

A compilation, however, provides little or no assurance of the credibility of the figures presented and would typically be accepted only for interim statements.

In general, statements prepared by the contractor's staff are not acceptable to sureties because they are difficult to verify and lack the approval of an independent auditor. While sureties may offer modest programs based on review or compilation statements, audited financial statements are most often required, especially for larger work programs.

Commitment

The surety company expects the contractor to perform its contractual obligations under the bond. Surety companies usually require a demonstration of commitment from the construction company's owners through personal and/or corporate indemnity.

The indemnity agreement obligates the named indemnitors to protect the surety company from any loss or expense incurred by the surety on behalf of the contractor. For example, these losses and expenses caused by the contractor's failure to fulfill its bonded obligation on the project are recoverable under the indemnity agreement. This gives the surety company some assurance that the contractor will stand fast in the face of problems and use its talent and financial resources to resolve any difficulties that may arise in the performance of the bonded work.

Surety companies stand behind the commitments undertaken by a contractor through a bonded contract. The contractor is primarily responsible to fulfill the contract's obligations and the surety's obligations are secondary to the contractor's. Surety bond premiums are service fees for the surety's expertise, underwriting services, and financial backing.

After the bonds are written, the surety continuously evaluates the overall performance and financial position of the contractor. Adverse changes may cause the surety to reduce or terminate the bonding program, whereas positive results may serve as the basis for an increase in surety capacity.

Sufficient lead time should be allowed when seeking surety bonds—especially when seeking a bond for the first time. *In no event should a bid be submitted for a bonded project before surety arrangements are in place.*

What do Bonds Cost?

Surety bond premiums vary from one surety to another, but can range from 0.5% - 3% (closer to 3% if the SBA Surety Bond Guarantee Program is used) of the contract amount, depending on the size, type, and duration of the project and the contractor. Typically, there is no direct charge for a bid bond, and in many cases, performance bonds incorporate payment bonds and maintenance bonds.

When bonds are specified in the contract documents, it is the contractor's responsibility to obtain the bonds. The contractor generally includes the bond premium amount in the bid, and the premium generally is payable upon execution of the bond. If the contract amount changes, the premium will be adjusted for the change in contract price. Payment and performance bonds typically are priced based on the value of the contract being bonded, not necessarily on the size of the bond.

Benefits of Bonding

The surety industry is an integral part of the construction business. A good surety underwriter and surety bond producer can be two of a contractor's greatest assets. The producer and underwriter are professionals who possess or have access to a wide variety of resources to assist contractors. They do all they can to see that a contractor remains viable. The surety team interacts with a cross section of the construction industry and can assist the contractor with:

- **Professional references**—The surety team knows accountants, bankers, and lawyers who understand the construction business.
- **Corporate experience**—Producers and surety company personnel can share their experience on issues facing a contractor.
- **Funding verification**—This service becomes very important if a contractor is involved in private construction. Many contractors have faced bankruptcy because they did not ask the source of funding on private projects. The surety will insist on knowing the source and adequacy of funds before it will commit to bonding a project.
- **Contract reviews**—Many sureties perform contract reviews to identify contract terms, general condition requirements, or anomalies in the specifications, or bond forms that may be onerous, unacceptable, or add undue risk to the project.
- **Continuity plans**—Sureties can assist the contractor with a continuity plan to protect the contractor's family, estate, partners, creditors, employees, and assets.

Maintaining the Surety Relationship

To maintain and increase surety capacity, it is important for a contractor to develop and maintain an ongoing relationship with the underwriter and producer. Developing a relationship requires commitment, trust, and, above all, communication. Maintaining the relationship through open communication and timely reporting on the company's financial condition and job status builds trust with the surety.

Maturing into a growing partnership requires teamwork and an organized effort among the contractor, the surety underwriter, and the surety bond producer. There may be difficult times, and the surety may not always be willing to extend the surety capacity the contractor would like, but maintaining a relationship with the surety company builds trust and increases the surety's commitment to the contractor over time.

Conclusion

Even after all the information is provided to the surety, there is no guarantee it will result in approval. The bond will be approved only if the surety is confident the contractor is qualified to perform the contract and work program successfully and has the financial capacity to withstand the numerous risks involved in the construction business. The decision to seek surety bonds should be based on long-term considerations. To obtain bonds, some changes in the way a contracting firm does business may be necessary, and these changes could have associated costs and benefits.

Resources

U.S. Small Business Administration (SBA)
For information on the SBA Surety Bond Guarantee (SBG) Program that helps small and emerging contractors obtain bonds, visit suretyinfo.org/?wpfb_dl=65.To contact the SBA Office of Surety Bond Guarantees, go to www.sba.gov/surety-bonds or call 202-205-6540.

National Association of Surety Bond Producers (NASBP)
NASBP is a resource for information about the role of the bond producer and how to find a producer in your state, bond assistance programs and surety industry information. NASBP also offers many educational opportunities and programs. Go to suretylearn.org for additional resources and about how small and emerging contractors can obtain surety credit. Contact NASBP at www.nasbp.org, 202-686-3700, or info@nasbp.org.

The Surety & Fidelity Association of America (SFAA)
For information on current surety industry information and issues, contact SFAA at www.surety.org, 202-463-0600, or information@surety.org.

Surety Information Office (SIO)
Contact SIO at www.sio.org or sio@sio.org for free publications including:

- The Importance of Surety Bonds in Construction
- Helping Contractors Grow: Surety Bonding for New & Emerging Contractors
- Surety Companies: What They Are & How to Find Out About Them
- The Importance of Surety Bonds in Construction

For more information on building a relationship with a surety bond producer and a surety company, visit www.sio.org.

Surety Information Office (SIO)

www.sio.org
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The Surety Information Office (SIO), formed in 1993, disseminates information about the benefits of contract and other forms of surety bonding in private and public construction. SIO, a virtual office, is supported by the National Association of Surety Bond Producers (NASBP), www.nasbp.org, and The Surety & Fidelity Association of America (SFAA), www.surety.org. For information on the benefits of surety bonds in construction and in other contexts, contact the Surety Information Office at sio@sio.org.

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The National Association of Surety Bond Producers (NASBP), founded in 1942, is the association of and resource for surety bond producers and allied professionals. NASBP producers specialize in providing surety bonds for construction contracts and other purposes to companies and individuals needing the assurance offered by surety bonds. NASBP producers engage in contract and commercial surety production throughout the U.S., Puerto Rico, Guam, and a number of countries. They 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 the underwriting requirements for surety credit.

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The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship worldwide. 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 the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies.