

## How to Obtain Surety Bonds

*Federal, state, and local governments require surety bonds in order to manage risk on construction projects and taxpayer dollars. However, surety bonds are not limited to public construction. Many private project owners stipulate bonding requirements on their projects and general 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. Since the bond is underwritten with little expectation of loss, the premium is primarily a fee for prequalification services.

### How to Begin

Since most surety companies distribute surety bonds through the agency system, the first step is to contact a professional agent or broker 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.

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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** protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
- The **payment bond** assures that the contractor will pay specified subcontractors, laborers, and material suppliers associated with the project.

### 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 view at the contractor's entire business operations and must be satisfied that the contractor is capable of completing the project. The underwriter may also request a meeting with the contractor to form his or her opinion and obtain additional information.

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 if the contractor's results are consistent. However, if there are 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 tell all parties how well the contractor is performing.

### Prequalification Process

Before a surety underwrites a bond, the contractor typically undergoes a careful, rigorous, and thorough process, often referred to as a prequalification. The prequalification process takes time as the producer collects information, answers questions the surety underwriter may have, and assists in verifying information.

The following is a list of items that the contractor may need to provide:

- An organization chart of key employees and their responsibilities
- Detailed resumes 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
- A continuity plan outlining how the business will continue in the event of the owner's death or disablement
- Evidence of a bank line-of-credit to augment working capital and to handle temporary cash flow deficits or strains
- 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). Depending on the time that has elapsed since the prior 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.

Financial statements are only as good as the accountant preparing them. That is why it is important to select a CPA who is knowledgeable of construction accounting. 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. While sureties may offer modest programs based on review or compilation statements, audited financial statements are most often required, especially for larger work programs. 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.

## Commitment

The surety expects the contractor to perform its contractual obligations under the bond. Surety companies usually require 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 caused by contractor's failure to fulfill its bonded obligation on the project and any resultant loss under the surety bond.

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.

## What do Bonds Cost?

Surety bond premiums vary from one surety to another, but can range from one-half of one percent to two percent 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.

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## Win Pistons Tickets!

You could win 4 Detroit Pistons basketball tickets for the December 10 (Thursday) game against the Denver Nuggets! Just complete the form below and fax it to 248.273.6837 by November 12.

First Name

Last Name

Title

Company Name

Phone Number

Address

City

A random drawing will be held on November 13, 2009, to determine the winner. Entries must be received by November 12, to be eligible. One entry per company please. The winner will be notified by phone on November 13, and his/her name will appear in next quarter's newsletter.

The winner of last quarter's Detroit Tigers tickets drawing was Deborah Murley of Superior Excavating.

Congratulations, Deborah!

## The Lighter Side

### Super Granny

An elderly lady had just finished her shopping and, upon returning to her car, found four males in the act of leaving with her car. She dropped her shopping bags and drew her handgun, proceeding to scream at them at the top of her voice, "I have a gun and I know how to use it! Get out of the car you dirty rotten scoundrels!"

The four men didn't wait for a second invitation but got out and ran like mad, whereupon the lady, somewhat shaken, proceeded to load her shopping bags into the back of the car and got into the driver's seat.

She was so shaken that she could not get her key into the ignition. She tried and tried and then it dawned on her why. A few minutes later she found her own car parked four or five spaces farther down. She loaded her bags into her car and drove to the police station.

The sergeant to whom she told the story nearly tore himself in two with laughter and pointed to the other end of the counter, where four pale white males were reporting a car jacking by a mad elderly woman described as white, less than 5' tall, glasses, and curly white hair carrying a large handgun.

No charges were filed.

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### **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.

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