Surety Association of Canada
Association Canadienne de Caution

The Voice of Surety in Canada
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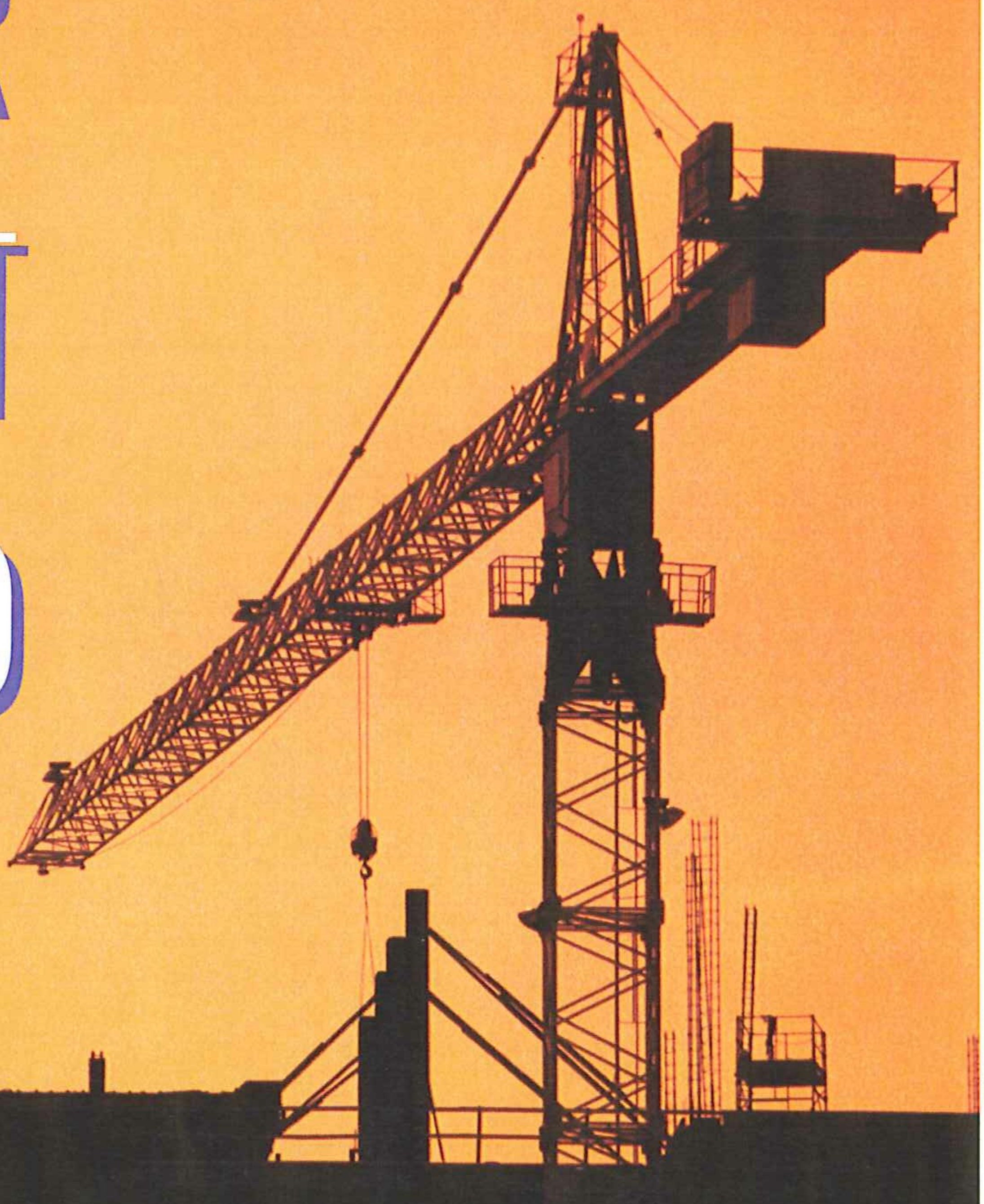
YOUR FIRST BOND



An introduction to corporate surety bonding for contractors considering projects that require bid, performance and payment bonds.

Today's construction industry is more competitive than ever, and more contractors are interested in projects that require them to provide surety bonds guaranteeing their performance of the contract.

WHAT IS A SURETY BOND?

Surety bonds are usually required of general contractors on public projects. However, many subcontractors also find that they are being asked to provide bonds, and an increasing number of private project owners are requiring bonds as well.

Simply stated, a surety bond is an agreement under which one party, **the surety**, guarantees to another, **the owner or obligee**, that a third party, **the contractor or principal**, will perform a contract in accordance with contract documents. In the case of a subcontract, the general contractor is the **obligee**, and the subcontractor is the **principal**.

There are three types of contract surety bonds. The first, **the bid bond**, provides financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the price bid and provide the required performance and payment bonds.

The second, **the performance bond**, protects the obligee from financial loss should the contractor fail to perform the contract in accordance with the terms and conditions of the contract documents.

The third kind of contract bond is **the labour & material payment bond** which guarantees that the contractor will pay certain subcontractor, labour and material bills associated with the project.

HOW TO GET SURETY BONDS

Since most companies that issue surety bonds work through agents and brokers, (also called producers,) your first step if you think you want to take on bonded work, is to discuss your plans with one of these representatives. You will find that a broker who specializes in surety bonding for the construction industry will likely be best qualified to assist you.

The professional surety broker will guide you through the bonding process and assist you in establishing a business relationship with a surety company.

Even though most surety companies are also large insurance companies, qualifying for bonds is more like obtaining bank credit than purchasing insurance. Like your bank, a surety company wants to know you well before committing its assets.

Most contractors find that it is necessary to spend a lot of time and effort establishing their first relationship with a surety company. Since the surety is guaranteeing your company's performance, it needs to gather and analyze carefully much information about you and your firm before it will agree to provide bonds.

PREQUALIFICATION

The surety underwriting process is focused on prequalifying the contractor. It takes time—sometimes a lot of time—to develop and present data, address questions the surety may have, and verify information.

Before issuing a bond the surety must be fully satisfied that the contractor is of good character, has the experience that matches the requirements of the projects to be undertaken, and has, or can obtain, the equipment necessary to perform the work.

The surety also wants to make sure the contractor has the financial strength to support the desired work program, and has a history of paying subcontractors and suppliers promptly. It will want to see that the contractor is in good standing with a bank and has established a line of credit.

In short, the surety wants to be satisfied that the contractor is a well-managed, profitable enterprise who keeps promises, deals fairly and performs obligations in a timely manner.

It is important to realize that each surety company has its own underwriting standards and requirements. But there are fundamentals that are common to underwriting surety bonds, and understanding these fundamentals is helpful to a contractor seeking surety bonds for the first time.

If you understand what's involved in getting bonds, you can weigh the time and expense of obtaining surety bonds against the benefits of being able to take bonded projects. Your decision to seek surety bonds should be based on long-term considerations. To obtain bonds, some changes in the way your firm does business may be necessary and these changes could have certain costs.

HERE'S WHAT YOU NEED

Let's take a look at the kind of information you may need to provide to your surety agent or broker in order to prepare your case for bonds:

- An **organizational chart** that shows your key employees and their responsibilities;
- Detailed **resumes** of yourself and your key people;
- A **business plan** outlining the type of work you do, how you obtain your jobs, the geographic area in which you operate, and your growth and profit objectives;
- A description of some of your **largest completed jobs**, including the name and address of the owner, the contract price, the date completed and the gross profit earned;
- A plan outlining **how the business will continue** in the event of your death or disablement, or that of another key employee (your surety broker may suggest that your plan include life insurance on key people, with your company named as beneficiary);
- Subcontractor and supplier **references** including names, addresses and telephone numbers of persons to contact (the surety will probably also order an independent credit report on your firm);
- Evidence of a **line of credit** at your bank; and,
- **Letters of recommendation** from owners, architects and engineers.

FINANCIAL STATEMENTS

Financial statements are vital to any business that grants credit, and sureties are no exception. Depending on how long your firm has been in business, the surety will want to see fiscal year-end statements for the last three to five years.

Your financial statements should include the following:

The **Accountant's Opinion Page** which discloses whether the statements were prepared according to audit, review or compilation standards.
The Balance Sheet which shows the assets, liabilities and net worth of your business as of the date of the statement. This helps the surety company assess the working capital and overall financial condition of your company.
An Income Statement which measures how well the business performed. The surety will assess each item, including gross profit on contracts, operating profit and net profit before and after tax provisions.
A Statement of Cash Flow which discloses the cash flow movements from operating, investing and financing activities.
Schedules of Contracts in Progress and Contracts Completed which show the financial performance of each contract and provide insight into the potential for future earnings from contracts in progress.
A Schedule of General and Administrative Expenses which may reveal how well overhead expenses are controlled and managed.
Any Explanatory Notes that the accountant may have included with the statements.

The surety may also require aging schedules of accounts receivable and payable as well as schedules for any other items on the statements that might need such support.

QUALITY OF FINANCIAL STATEMENTS

Financial statements can be prepared by accountants on three levels, referred to as an audit, review and compilation.

Sureties prefer audited fiscal year-end statements, but there are occasions when a surety may accept a review statement.

A **review statement**, which is far less comprehensive than an audit, consists principally of inquiries of your company's people and the application of certain analytical procedures to the financial data. Although far narrower in scope than a full audit, the review does provide some limited assurance about the financial statements.

A **compilation** or **"notice to reader"**, however, provides no assurance, or very limited assurance, as to the credibility of the figures presented because the accountant is not required to follow normal audit procedures or acceptable accounting principles.

In general, neither statements prepared by your own staff nor compilation statements are acceptable to sureties because they are difficult to verify and lack the stamp of approval of an independent auditor.

So, while sureties may offer modest programs based on review statements, the trend is toward requiring **audited** financial statements. Many sureties will insist that at least the most recent fiscal year-end statements be prepared to **full audit** standards.

Complete and accurate cost recording and accounting systems are extremely important to surety companies. Without these systems, the contractor may not be able to identify and correct problems before they become too severe.

Depending on the time elapsed since the last fiscal year-end statement, the surety may ask for an interim financial statement to show how the current year is progressing. While the requirement for interim statements varies, a six-month statement is usually minimum.

WORK IN PROGRESS SCHEDULE

You will also need to prepare a schedule of work in progress, probably quarterly. This schedule should list each job by name and indicate the total contract price, including:

- change orders;
- amount billed to date;
- cost incurred to date;
- revised estimate of the cost to complete;
- estimated gross profit; and, the
- anticipated completion date.

The format of this exhibit and the amount of information required varies among surety companies.

SUBMITTING YOUR CASE TO THE SURETY

Once your file is completed by your surety producer, it will be submitted to a surety company for review. The company's underwriter may ask to meet with you and your key people. You should be prepared to discuss all aspects of your company's current operations and future plans; for example, surety companies usually like to have some idea as to the single job size and aggregate workload—including all projects, bonded or not—that you want to undertake.

Once the basic arrangements are completed, the surety will be in a position to consider specific bond requests. The underwriter will examine each request and review the terms and conditions of the contract documents and bond forms. If they are found unacceptable, the surety may decline to write the bond even though the other underwriting factors are favourable.

PERSONAL INDEMNITY

Since surety bonds guarantee a firm's performance and payment of bills, the surety fully expects that the contractor will live up to those obligations. Therefore, you will be asked by the underwriter to sign an indemnity agreement. This indemnity will be required of the contracting firm and may also be required of the firm's owners and their spouses.

The indemnity agreement obligates the named indemnitors to protect the surety from any loss or expense, thus assuring that they will stand fast in the face of problems and use their talents and financial resources to resolve any difficulties that may arise in the performance of the bonded work.

After the bonds are written, the surety will continuously re-evaluate the overall performance and financial position of the contractor. Adverse changes may cause the surety to reduce or terminate the bonding program, while positive results may serve as the basis for an increase in the amount of bonds available.

ALLOW SUFFICIENT TIME

It is important to realize that sufficient lead time should be allowed when seeking bonds—especially for the first time. In no event should a bid be submitted for a bonded project before surety arrangements are in place.

To bid a project first and then seek the necessary bonds may invite trouble for you and cause the surety to conclude that you have acted hastily or imprudently.

IN CONCLUSION

We have discussed generally the type of information surety companies may require for a first bond. Again, keep in mind, that each surety has its own underwriting standards and may require additional or different information.

Even then, there is no guarantee that submitting all of the requested information will result in an approval. The bond will be given only if the surety feels the contractor is qualified to perform the contract successfully.

You may be wondering about the cost of surety bonds. **Surety rates vary from one surety to another and your surety broker can advise you as to the rates available in the marketplace.**

SEEK A PROFESSIONAL AGENT

As you now realize, the surety prequalification process is very thorough. That is why we have stressed the importance of choosing a professional surety producer to guide you through this process.

If you are not sure how to find a broker who is a specialist in contract surety bonding and insurance, you can contact the Surety Association of Canada at (905) 677-1353, fax us at (905) 677-3354 or email us at Surety@Compuserve.com

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