

MITIGATE RISKS AND MAXIMIZE RESOURCES WITH SUBCONTRACTOR PREQUALIFICATION

Article by:

Christopher E. Hartle, CPA

Senior Manager / Team Leader
Construction Client Service Team



BARNES DENNIG

Accounting • Tax • Business Insight



Mitigate Risks and Maximize Resources With Subcontractor Prequalification

By Christopher E. Hartle, CPA, Barnes Dennig

What kind of gambler are you? Do you go all-in on little more than a gut feeling? Do you play it safe, folding every time you have a less-than-perfect hand? Or do you take calculated risks, hedging your bets and watching for signs that the cards are stacked against you?

Owning a business, especially a construction company, always involves taking risks. Many of these risks aren't controllable, such as the weather and economic conditions. Other risks can be managed, but not entirely eliminated. Subcontractor failure is one of those risks, and it has increased in recent years.

Until recently, general contractors usually went with the low bidder. But as work became harder to find, more subcontractors started bidding jobs they didn't have the skills, financial strength or manpower to perform. Even previously strong subcontractors now find that circumstances can turn against them quickly.

Case in point: A large GC had worked with a successful subcontractor for some time, experiencing no performance problems. A senior executive of the GC, who had a personal friendship with the subcontractor, chose not to bond the company's performance on a federal project. Due to some unforeseen circumstances on other jobs, the sub is now bankrupt, and the GC is left with a \$500,000 tab.

Subcontractor failure is no longer a risk that can be ignored. Just one subcontractor bankruptcy can take a GC down as quickly as problems within the GC's own operations. The risk is particularly high when working with new subs or expanding into new territories.

For all of these reasons, GCs are more consistently and methodically prequalifying their subcontractors and monitoring the performance and financial strength of those subs. While prequalification certainly benefits the GC, it also benefits the subcontractor by keeping the sub focused on jobs with which it has the greatest chances of success and making it easier for vendors and suppliers to do business with them.

Subcontractor Prequalification Process

The prequalification process is all about making the best use of everyone's time and resources. Today, few sizeable GCs will hire a subcontractor who has not been pre-qualified. On the flip side, some GCs offer incentives, such as accelerated payment terms, to preferred subcontractors.

The prequalification process typically involves the following:

- Review of a prequalification questionnaire, financial statements, insurance certificate, safety information and any other required documents
- A site visit or meeting between the GC and sub
- Reference checks and word-of-mouth

After this thorough review, the GC will judge the strength and stability of the subcontractor, which determines the size of the subcontract they qualify for and any additional risk management techniques that might be necessary. While the specific



questions will vary, most GCs want to determine four things about the subcontractor: character, competence, capacity and capital.

Character

The GC wants to know who is running the ship, how long they have been in business, and whether they have a history of nonperformance (either failed contracts or contracts terminated for performance). A standard subcontractor prequalification form will ask if the company or any of its owners have ever filed bankruptcy or had any claims or litigation against them. On the flip side, they also want to know of any litigation or claims the sub has pursued against others.

Another important indicator of the subcontractor's character is the company's safety history and practices. Most GCs will want to know the sub's Workers' Compensation Experience Modification Rating, and they expect it to be 0.75 or lower. OSHA violations can be another mark against the sub, especially when bidding on federal projects. A written safety policy that is strictly followed works in the subcontractor's favor, as does a written ethics policy.

Competence

GCs need assurance that the subcontractor has experience and expertise in the types of jobs on which they are bidding. The prequalification form will generally ask for references from previous clients, suppliers, bankers and surety companies. It will require a list of jobs, along with the size of the subcontract, completed in recent years.

Experience in the geographical area that the GC serves is another important factor. If the sub doesn't have the resources to deploy to remote locations, it's best for everyone if the company doesn't bid on those jobs. Conversely, if the sub does have resources and expertise in locations that are outside the GC's typical service area, that information can come in handy if and when the GC gets an opportunity in the region.

Capacity

Most prequalification forms will ask for a list of current projects under contract or in the pipeline. Combined with information about volume that the subcontractor has completed in the past and size of the subcontractor's workforce, the GC can begin to paint a picture of the sub's capacity to handle additional work. A GC might also ask to inspect the subcontractor's yard or shop facilities to ensure they have the necessary equipment to do the work.

Savvy GCs want to make sure their subcontractors are not stretching their limitations. They know that, when a contractor is spread too thin, something's got to give. Requiring a performance or payment bond is one way GCs mitigate the risk that their project is the one that will fall through the cracks. (See *Risk Management Options*, below.)

Capital

More GCs today require financial statements or tax returns to verify the sub's financial strength. Not all subcontractors are comfortable opening up their books – especially if the business represents their entire net worth. Subcontractors are more likely to hand over financials if the GC assures them that the documents are kept confidential and are shredded after the prequalification process. One large GC includes the following note in its prequalification form: "The information requested is used by our CFO and Vice President as a necessary risk management tool in this current economic climate. These documents are kept confidential and are shredded upon executive review."



In reviewing financial statements, a CFO will look for a few key indicators of the subcontractor's financial strength:

- **Are the financial statements properly prepared?** Ideally, the GC will want to see financial statements prepared by a CPA who knows construction. A tax return with a balance sheet also conveys similar information. Internally prepared financial statements – such as a balance sheet generated from QuickBooks – are fine, as long as they are prepared by someone who understands the basics of construction accounting. An off-basis financial statement – one that is for a reporting period other than month-end – is an immediate red flag that the preparer is not financially savvy.
- **Does the subcontractor have sufficient cash?** Cash is the lifeblood of any organization. The financial statement should show a healthy overbilled status, and at least 90 percent of those overbillings should be in cash or accounts receivable. Subcontractors who spend all of their overbillings in the early part of the project are more likely to run out of cash to pay suppliers and second-tier subs.
- **Do current assets cover current liabilities?** A subcontractor's current assets typically include cash and accounts receivable, while liabilities include accounts payable, overbillings and debts. If the right side of the balance sheet outstrips the left, the contractor will quickly be under water.
- **Are accounts receivable in line with income?** Generally, accounts receivable should rise from year to year, but only if income also is increasing. Growing accounts receivable during a period of declining volume could indicate that there are disputes or legal claims related to work performed, or that an owner or GC with whom the sub is contracted is having financial difficulty.
- **Is the subcontractor keeping sufficient equity in the business?** As business dries up, some construction company owners might spend their equity trying to keep the company alive. Without this source of working capital, the business may not have the funds to pay its own subcontractors and suppliers, or the entire business could fail with little notice. Low working capital also can lead to a decrease in bonding capacity.
- **What are the subcontractor's liabilities?** Does the business have huge credit card payables? Have the owners maxed out their line of credit? If so, what other sources of funding do they have to cover materials and labor while they wait on their first progress payment?
- **How do revenues compare to expenses?** If revenue is going down and general and administrative expenses are going up or even staying the same, the business won't be able to sustain that trend. It can also be a warning sign that the owners have seen the writing on the wall and are paying themselves as much as they can before they go out of business.
- **What are they disclosing?** Financial statement disclosures can reveal a lot about the subcontractor's financial status. For example, is the bank requiring a personal guarantee on a loan? Has the company failed to meet debt covenants? Disclosures also are required to report contingent liabilities, or liabilities that might be incurred depending on the outcome of a future event, such as a claim or bankruptcy of a customer.



Risk Management Options

Certain factors contribute to a determination that a subcontractor is more risky and therefore requires a higher level of risk management:

- Refusal to provide financial statements or tax return
- Shoddy presentation of financial statements
- Lack of financial strength
- History of performance problems or claims
- Safety violations
- No prior work history with the GC
- No or limited experience in the geographic area

Based on the above risk factors, the GC will decide which of the risk management tools are necessary. Below are descriptions of some of the tools at their disposal.

Limit Contract Value

Subcontractors who can't provide solid financials or who have a shaky credit history can't expect to be qualified to perform a million-dollar subcontract. Follow-through is important. Once a contract limit has been set, that limit must be communicated and enforced consistently.

Vendor Disclosure and Joint Checks

GCs who are nervous about the subcontractor's ability to pay its suppliers and vendors might require the sub to submit a disclosure form along with its monthly bill, which lists all vendors used that month. If the GC finds that vendors are not being paid timely, then it might start issuing checks that are payable jointly to the subcontractor and the vendor. One caveat: The increased use of remote banking has eroded the reliability of joint checks. The lower level of review allowed by Internet and mobile banking means that one party can often deposit the check without the authorization of the other.

Bonding

Bonding every subcontractor on a job typically is not desirable or even possible. The cost of the premiums, which usually range from 0.5% to 2% of the contract amount, would quickly drive the bid out of competitive territory. However, in cases where the subcontractor is an unknown entity or is working in a new geographic location, bonding might be the best risk management option. Remember that a subcontractor who is struggling will be more likely to dedicate resources to the bonded project, since personal assets often are on the line.

Personal guarantee

If all of the above practices fail to adequately protect the GC, then a personal guarantee from the owner of the subcontracting company might be necessary on each subcontract executed.

Ensure Subcontractor Performance

In addition to the above risk management practices, certain practices can help GCs ensure the quality and financial strength of their subcontractors:

- **Use a third party to conduct subcontractor prequalification.** Some surety companies offer prequalification for a fee. Not only are subcontractors often more willing to share financial statements with a surety, if the surety also writes bonds for the subcontractor, it will be aware of the owners' personal assets.



- **Use a firmwide database to track and communicate exceptions.** If a subcontractor is only qualified for subcontracts of less than \$10,000 and joint checks are required on all payments, are the project managers aware of those requirements? What about the accounting department?
- **Monitor subcontractors on a regular basis.** Project managers should immediately report any performance issues up the chain of command. Requests by the subcontractor for more frequent payments also should send up a red flag, as should difficulty manning the job.
- **Re-qualify subs once a year.** At the very least, ask for updated financials. Allocate at least a portion of someone's job to monitoring and managing subcontractor relationships.
- **Foster a company-wide commitment to following the prequalification process.** The corporate culture should reinforce the importance of strong subcontractor relationships. Share stories of how subcontractor failures have cost the company money, and how strong subcontractors have contributed to profitable jobs.

Subcontractors can improve their standing in the eyes of GCs by following these best practices:

- **Focus on quality, not quantity.** Much depends on your work history, and one failed job can limit your chances of securing future work. Maintain high quality of work and timeliness by not overextending your resources.
- **Rely on the experts to help keep your business healthy.** Use a construction-focused CPA to prepare and review financial statements and maintain a strong bonding relationship. In addition to the peace of mind the bond provides for the GC and project owner, the surety can be a source of assistance to the subcontractor if things get rocky.
- **Complete the prequalification process thoroughly and comply with all of the GC's requests.** The GC will draw conclusions about your work ethic and level of performance by the attention to detail shown in the application process.

Make A Smart Bet

Prequalification is a valuable risk-mitigation process for everyone involved. The GC saves time in the bidding process and avoids the expense of covering for a failed subcontractor. The owner avoids liens and the general chaos caused by a subcontractor bankruptcy. The subcontractor avoids wasting time and resources on jobs that are beyond its capabilities. Suppliers are better protected, making them more willing to extend favorable payment terms to prequalified subs.

Remember: Even subs with a strong history of quality performance are subject to the whims of chance, so don't rely on a roll of the dice. A thorough prequalification process and the support of a construction-focused CPA firm can help ensure a positive outcome for everyone.



For more information, contact Chris Hartle at chartle@barnesdennig.com or (513) 241-8313.



Christopher E. Hartle, CPA Senior Manager / Team Leader

Chris leads the firm's construction client service team, offering valuable insight and expert recommendations into issues from financing to operations to employee benefit plans. He is adept at not only helping his clients strengthen their bottom line but also understand the strategies that make such success possible.

In his 13 years at Barnes Dennig, Chris has worked closely with a number of clients to identify accounting improvements and streamline their processes and systems. He has a particular expertise in information technology, helping clients utilize their accounting software to its fullest capability. He also manages an engagement team for employee benefit plan audits.

In every role, Chris's goal is to educate his clients along the way, helping them gain a deeper understanding of the accounting requirements they face and the many ways it can impact a company.

He is a member of the editorial advisory board of *ProfitCrew*, which provides regular and insightful content for the construction industry. He also serves on Barnes Dennig's Accounting and Auditing Quality Control Committee. In this role, he helps the firm deliver the highest quality assurance services, which in turn provides clients with increased peace of mind.

Chris graduated from Miami University with a double major in accounting and finance. He is a Certified Public Accountant (CPA) licensed in Ohio and is a member of the Ohio Society of Certified Public Accountants (OSCPA) and the American Institute of Certified Public Accountants (AICPA).

Industry Focus:

Construction
Real Estate
Distribution

Professional

Affiliations:

AICPA
OSCPA

Education:

Miami University
Oxford, OH