Construction
Industry Advisor

WINTER 2016

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Prequalification reduces risk of subcontractor default

General contractors can no longer afford to just award subcontracts to the lowest bidder. In today's challenging economy, some subcontractors bid on jobs that are outside their comfort zones in terms of skills, capacity or financial resources. In today's world, prequalifying subcontractors is essential to ensure that subcontractors have the wherewithal to complete their work in a satisfactory manner and to minimize the risk of default.

Prequalification benefits subcontractors as well. By taking steps to secure a spot on local GCs' "preferred subcontractor" lists, they can gain a competitive edge.

The prequalification process

Consider formalizing the prequalification process by creating a set of forms, questionnaires and checklists for gathering information from prospective subcontractors. Some vendors offer prequalification software that helps streamline and automate the process.

Another option is to engage a third party — such as a surety company — to prequalify subcontractors on your behalf. One advantage of this approach is that subcontractors may be more comfortable sharing financial statements and other information with a surety.

Review subcontractors' financial statements or tax returns to evaluate their financial health and verify that financial statements conform to Generally Accepted Accounting Principles.

What to look for in a subcontractor

There isn't one right way to prequalify subcontractors. The type of information you gather will depend, in part, on the nature of your business and the size and complexity of your jobs. Following is a partial list of things you should look for when vetting subcontractors:

Management team and ownership. Gather information about the owners and the current management team, how long they've been in place, and their backgrounds. Has the company ever been terminated for nonperformance or walked off a job? Has the company or any of its owners ever filed for bankruptcy? Does it or any of its owners or management have a history of litigation, either as the defendant or plaintiff? Dig into

the company's history and practices. What is its Workers' Comp Experience Modification Rating? Does it have a history of OSHA violations?

Consider visiting a subcontractor's facilities and speaking to its employees to get a feel for whether its operations are well run, organized and safe.

Work quality. It's critical to ensure that subcontractors have the skills and experience necessary to perform the type of work called for on a particular job. Ask subcontractors to provide a list of their jobs in recent years, including the nature of the work and the size of the subcontract. Request references from GCs and other customers, lenders, sureties and suppliers. You might even ask to visit one or two of their jobsites to examine the quality of their work firsthand.

Capacity. Even if a subcontractor is competent and has a quality management team, it's risky to do business with a company whose workforce is spread too thin. So it's important to satisfy yourself that prospective subcontractors have the capacity to handle your work. Ask for information about the size and skills of the subcontractor's workforce, as well as a list of current and upcoming projects. This information, together with information about the volume of work the subcontractor has handled in the past, will give you an idea of the subcontractor's capacity to take on additional projects. And consider inspecting a subcontractor's facilities to confirm that it has the equipment it needs to handle a job.

Financial resources. Review subcontractors' financial statements or tax returns to evaluate their financial health. Verify that financial statements conform to Generally Accepted Accounting Principles (GAAP) — preferably audited by, or prepared with the assistance of, a CPA with construction experience. Extracting key ratios from the financial statements can help you gauge a subcontractor's financial strength. (See "Key financial ratios" at right.)

As you review the financial information, pay particular attention to whether a subcontractor has enough cash to keep its business going, and that its accounts receivable are appropriate to its income level. Make sure the owners are maintaining sufficient equity in the company. Finally, get input and assistance from your CPA to better analyze and interpret the subcontractor's financial data.

Key financial ratios

There are several ways you can measure a subcontractor's financial health. Here are just a few:

Current ratio (current assets / current liabilities). Measures the subcontractor's ability to satisfy its short-term liabilities with cash and other relatively liquid assets.

Return on equity (net earnings / total net worth). As a general rule, the higher this ratio the better. But in some cases, a high ratio may indicate that the subcontractor is undercapitalized or too highly leveraged.

Working capital turnover (revenue / working capital). Indicates the amount of revenue supported by each dollar of net working capital used. A higher ratio may signal a need for additional working capital to support future growth.

Debt-to-equity (total debt / net worth). Some degree of leverage is healthy, but too much is risky.

Underbilling / overbilling. If a subcontractor is underbilled — that is, if billings aren't keeping pace with its progress on jobs — it may signal cost overruns, lax management or sluggish billing practices. Financially healthy subcontractors typically maintain an overbilled status.

Managing your risk

If your due diligence reveals that a subcontractor presents a high degree of risk, you might decide not to do business with that subcontractor. Alternatively, there may be steps you can take to manage the risk, such as imposing a contract value limit on that subcontractor, requiring performance bonds or letters of credit, or obtaining personal guarantees from the owners. ■

Don’t neglect the cost to complete

On long-term construction projects, it’s critical for contractors to have systems in place to accurately estimate the cost to complete (CTC). Knowing a project’s CTC helps you develop a more accurate picture of the project’s performance to date, avoiding surprises that can hurt your profitability and shake the confidence of lenders and sureties. By getting a handle on your CTC early in a project, you have an opportunity to address problems that are hindering your productivity or otherwise increasing your costs.

Estimating the percentage complete

Typically, contractors use the percentage-of-completion (POC) method to account for long-term contracts. That method recognizes income as a contract progresses, in contrast to the completed contract method, which doesn’t recognize revenues or expenses until a project is substantially complete. Following is a simple example that illustrates the critical role CTC plays in measuring profitability.

Suppose a contractor enters into a contract to construct a commercial building. The contract price is $1 million and the contractor estimates its costs to be $900,000. At the end of year 1, the contractor has incurred $300,000 in costs and believes its original cost estimate of $900,000 remains accurate — that is, its CTC is $600,000. Based on the costs incurred to date, the project is one-third complete, so the contractor’s first-year profit is $33,000 [$333,000 (33.3% of the contract price) - $300,000 in costs].

There are several steps contractors can take to ensure they prepare accurate CTCs, such as developing solid project budgets and labor schedules.

But what if productivity issues have substantially increased the contractor’s labor costs? Suppose that, assuming current productivity rates continue for the remainder of the project, its actual CTC is $700,000. This would reduce the POC to 30%, wiping out the contractor’s profits. In addition, it’s likely that the contractor would need to increase its labor costs down the road in order to meet the original target completion date, turning a profitable job into a loser.

Misjudging CTC comes at a steep price

Failure to understand a project’s true CTC can cause a contractor to improperly recognize revenue, which in turn can lead to “profit fade.” If the contractor in the example above uses the inaccurate figure of $600,000 as its CTC, it will overreport its year-1 profitability and experience significant profit fade in the project’s remaining years.

If, on the other hand, the contractor estimates CTC accurately, two important things will happen: First, more accurate, consistent reporting will inspire confidence on the part of banks and

sureties. And second, it will provide an opportunity for the contractor to address its productivity issues or find other ways to reduce costs and boost its profitability.

There are several steps contractors can take to ensure they prepare accurate CTCs. These include:

- Developing solid project budgets and labor schedules (and updating them to reflect change orders and unforeseen developments),
- Implementing accurate systems for tracking and reporting productivity,
- Holding project managers accountable for monitoring a project's financial performance,
- Accurately estimating the direct costs of all remaining work, and
- Meeting or beating the budget.

A wise investment

It pays to invest needed time and resources in developing accurate CTC estimates for your projects. The benefits include more accurate financial statements, stronger relationships with banks and sureties, and higher, more consistent profits. ■

Why you should keep an eagle eye on your estimates

As a contractor, it's critical that you keep an eagle eye on a multitude of tasks. But, one task in particular that's susceptible to being overlooked is how you handle your estimates. If you aren't careful, you might just find yourself digging a hole into your profits.

Fixed price or approximate estimates?

The first thing to review when looking at your estimates is how they're being generated. Estimating methods tend to fall into two categories: fixed price and approximate.

Because they incorporate detailed information, fixed-price estimates are typically the most reliable method. Of course, as you well know, the contractor bears a bigger portion of the risk than the owner does because the job is set at a fixed price — even if costs rise higher than expected.

Many construction companies prepare fixed-price estimates on a lump-sum basis. That is, estimators compile a job's price after closely analyzing drawings, specifications and other bidding documents. They then calculate the costs of materials, labor, equipment, subcontractors, overhead and other job-related expenses before applying a markup to the total cost to obtain a lump-sum estimate.

You may also produce fixed-price estimates on a unit-price basis. Here, you submit the bid based on the individual line items. As with a lump-sum estimate, the result determines the total project cost. Your estimator, however, segregates expenses according to each line item's unit price.

The second method — an approximate estimate — is a shortcut that gives you only a rough idea of a project's cost. Estimators primarily look at expenses derived from previous jobs, refining their figures as they learn more project specifics.

Over a selected period — one calendar year is sufficient, though a two- to three-year sample size is best — look at how your construction company's estimates were generated. Are too many approximate estimates creeping in and

hurting profitability? Are your fixed-price estimates using updated materials costs and realistic labor data?

Are your estimations accurate?

Estimates are math — and the more complex the calculation, the more likely it will account for the many variables involved. Failing to apply an evolving profit margin calculation algorithm can reduce the value of jobs over time.

For example, if you estimate profitability on a flat, 10% sales price across most projects, you could lose money as changes and delays occur. Breaking down costs more specifically can prevent such losses. And there's no better way to do so than with today's estimating software.

Construction-specific estimating applications reduce errors and create a historical database to help you refine procedures and generate more accurate data for future projects. They can also relieve much of the drudgery associated with routine, repetitive and time-consuming calculations. So make sure your software is up to date.

Are your estimators qualified?

Your first and last line of defense in generating accurate estimates is the people doing the job. When reviewing estimators' performance or when hiring new ones, make sure you're employing professionals who can visualize project phases in great detail. They should also have good organizational and communication skills, a thorough knowledge of construction materials, processes and software, and the ability to understand today's more detailed drawings and specification documents.

No matter how skilled your estimators or what methods they use to prepare bids, it doesn't hurt to have another party occasionally check their work for accuracy. This person could be you, a project manager or even an outside consultant. When reviewing estimates, verify that the projected gross profit of each job is in line with your profitability objectives and the current bid market.

To help ensure accurate reviews of estimates, encourage estimators to work transparently; you must know how he or she arrived at the quoted job price.

Keeping your bottom line healthy

After you complete projects, go back and compare estimates with your actual job costs. Investigate projects that went under or over the original estimates to find out what went right or wrong and to learn from the process. Remember, the more accurately you estimate projects, the more precisely — and profitably — you can quote prices for quality workmanship. ■

The ins and outs of additional insured endorsements

General contractors (GCs) typically require subcontractors to procure a commercial general liability (CGL) policy and to name the GC as an "additional insured" under the policy. This practice is intended to protect the GC against liability in connection with the subcontractor's activities.

If you're a general contractor, don't assume that an additional insured endorsement provides the protection you seek. Rather than relying on a certificate of insurance, request a certified copy of the policy and review the actual language of the endorsement. Often, the coverage extended to additional insureds is narrower than that provided to the subcontractor.

Watch out for blanket endorsements

A blanket endorsement automatically confers additional insured status on a GC if the subcontractor is contractually obligated to name the GC as an additional insured. Be sure the construction contract clearly spells out a subcontractor's obligation to list you as an additional insured. Otherwise, you may not be covered.

Watch out for exclusions

It's not unusual for an additional insured endorsement to contain exclusions or other restrictions that limit the insurer's liability to the GC. For example, many policies exclude additional insured coverage for claims arising after the subcontractor's work is completed. In a recent federal court case, a GC learned this lesson the hard way.

The case of *Carl E. Woodward, L.L.C. v. Acceptance Indemnity Insurance Co.* involved construction defect claims that arose more than a year after construction was complete. The defects were

caused by a concrete subcontractor's failure to build foundation piers and other structural components in conformance with the plans and specifications. Although the defects were the subcontractor's fault, the Fifth U.S. Circuit Court of Appeals held that the subcontractor's CGL insurer had no duty to defend or indemnify the GC pursuant to the policy's additional insured endorsement.

The endorsement provided that the GC was included as an insured under the policy "only with respect to liability arising out of [the subcontractor's] ongoing operations performed for that insured." It also specifically excluded coverage for property damage occurring after the subcontractor's covered operations had been completed. The court found that the claims in this case arose out of the subcontractor's completed operations and, therefore, weren't covered by the additional insured endorsement.

Read the policy

To avoid unpleasant surprises, make sure you understand the level of protection provided by an additional insured endorsement *before* you sign the contract. Consider asking your subcontractors to provide you with coverage that extends to claims arising from completed operations. ■

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