

Subcontractor Prequalification

After the Great Recession

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Owners, GCs, and construction managers stake their companies' reputations and success on the quality of their workmanship and ability to complete jobs on time and within budget. Success or failure rests squarely with the management team and the subcontractors they hire to complete the job.

Total work performed by subcontractors on any construction job can reach as high as 90%. Just as the management team must survive rigorous interviews and background scrutiny before being hired, so should a key component of the team: the subcontractors.

Many contractors have faced eroding equity levels over the past several years and are struggling to keep their companies afloat while enduring low profit margins. Due to this economic environment, owners and GCs can no longer rely on reputation or lowest bid when hiring subcontractors.

A formal, standardized subcontractor prequalification procedure and annual update of preferred subcontractors are invaluable tools in contractor selection and retention for long-term success and increased profitability.

While this article will focus on the evaluation of subcontractors, it's important to recognize that GC selection can also follow the same types of analysis and evaluation by project owners.

Establish Selection Criteria

Establishing the selection criteria is a cross-departmental strategic issue, with priorities coming from upper management along with input from estimating, purchasing, finance, and the field. The CFM can be an instrumental driver in helping to identify the need for a detailed subcontractor prequalification process, establish the specific criteria, and implement the process. In addition, the CFM is the primary source for the financial criteria. The company's surety or an accounting firm (ideally with construction expertise) can provide additional perspective and ideas in this area.

There are eight primary areas of selection analysis:

- 1) General company overview
- 2) Licenses
- 3) Insurance
- 4) Bonding and financial
- 5) Legal and claims
- 6) Safety
- 7) Job experience
- 8) References

The four-page prequalification form at the end of this article provides sample questions relating to each category.¹ After the initial submission, periodic updates (no more than annually) of the information from any subcontractors bidding on new jobs and those performing work on active jobs will develop a trend for each subcontractor and its operating and financial environment to head off any surfacing problems.

WHAT IS THE SUBCONTRACTOR'S GENERAL COMPANY OVERVIEW?

This gives the first insight about a subcontractor's experience, number of years in business, number of employees, ability to adequately staff the job, geographic location, and any special company designations. Affiliations, organization membership, and additional information (e.g., LEED certifications) can easily be included in this area.

It is critical to verify pertinent facts about the company's history. For example, subcontractors may owe large amounts in back payroll taxes but continue to take on business. Another

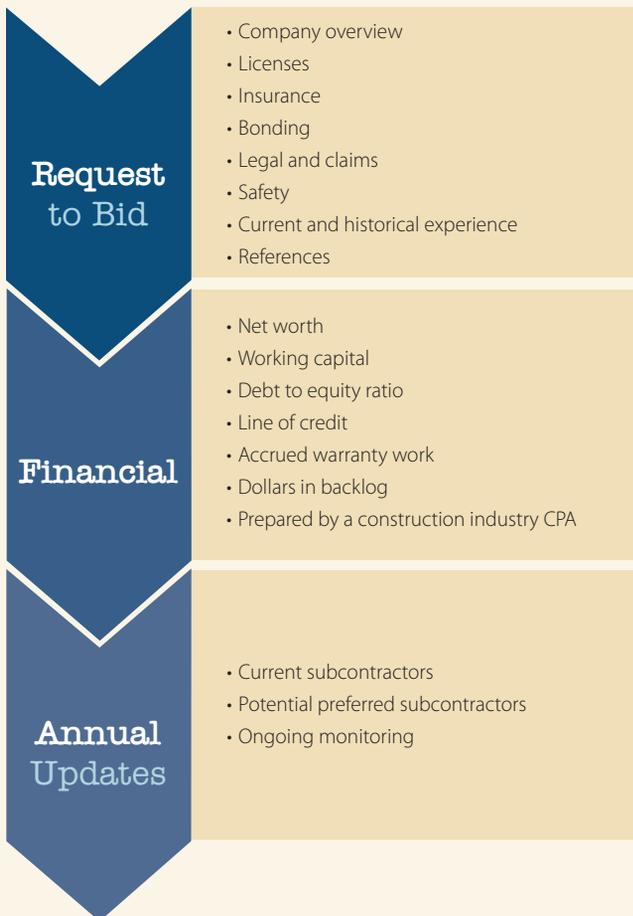


example is when contractors file for bankruptcy, but then open a new entity with a similar name and claim they have been in business for an extensive number of years.

DOES THE SUBCONTRACTOR HAVE PROPER INSURANCE & LICENSES?

Information provided on whether a subcontractor has the required licenses to perform work within the project's jurisdiction can easily be verified on state and local websites.

Providing standard insurance requirements enables subcontractors to confirm and document their eligibility before going any further in the bid process. This can eliminate job delays up front due to inadequate (or lack of) insurance and unnecessary risk taken on by the GC for a subcontractor without proper insurance. Some states have websites that allow you to confirm insurance. For example, www.myfloridacfo.com/WC/databases.html lists insurance database links to confirm current workers' comp coverage, workers' comp insurance history, and loss run activity in Florida.



WHAT IS THE SUBCONTRACTOR'S BONDING CAPACITY & FINANCIAL PICTURE?

Bonding Capacity

Since not all surety bonds are the same, always confirm a subcontractor's surety rating. The surety will quote surety capacity on a per job basis and in the aggregate. Sureties then bond each job up to a certain dollar threshold. In the aggregate, the surety would bond total jobs up to the aggregate amount. Understanding these levels will assist in evaluating the subcontractor's financial strength.

Financial Picture

Addressing Concerns

Financial information is a sensitive topic for subcontractors. One possible way to address concerns is to limit the request for financial statements until the process is down to the final two or three bidders, rather than with the initial bid. Another way to address concerns is to limit access to the information only to specific people within the company or destroy the financial information after performing analytics.

Equity & Working Capital

When reviewing a subcontractor's financials, first consider equity and working capital. A subcontractor's inability to meet its financial obligations usually stems from weak levels of equity and/or working capital.

Adequate working capital can indicate the subcontractor's ability to meet future obligations. Weaker working capital levels typically reflect cash flow concerns. A common generalization is that 10 times adjusted working capital (or equity) may be a good estimate of aggregate surety capacity.

Debt

When evaluating a subcontractor, a balance sheet with little or no long-term debt is generally more favorable. It's also important to review the financial statement footnotes for its total available line of credit and amount drawn down at the balance sheet date.

The subcontractor's access to cash and ability to meet a job's initial cash flow needs before the initial payment on a new job is received are positive indicators. This access to cash flow supports the necessity to meet the construction industry's retention requirements. Obviously, not paying down the line of credit for long periods can reflect poor cash flow. Remember to also consider such standard ratios as debt to equity when analyzing debt levels.



Reserves

Typically, subcontractors that are financially stable will reserve an expense for warranty work. If the warranty work is later required, then the balance sheet reserves would be offset for that work instead of negatively impacting future financial results.

A subcontractor can develop a reserve rate that is a portion of its annual volume as an approximation for future warranty work that might be required. Reserves like this match future costs to the period in which the work was initially performed and profits earned. A contractor's financial statement reflecting such reserves are typically more favorably viewed.

Current Work Levels

A subcontractor's current backlog can indicate financial health. But be careful not to read too much into this when reviewing recent years' financial statements because of the recent economic downturn. Also, consider a comparison to objective survey data. For example, according to *CFMA's 2012 Construction Industry Annual Financial Survey*, respondents reported slightly more than 10 months of backlog.

While backlog is not an absolute indicator of financial health, it's still valuable to know how many dollars of backlog a subcontractor has as of a specific date. A CPA-prepared financial statement with footnotes will include a backlog schedule. Conversely, remember that too much backlog can negatively impact a company's management and cash flow.

WHAT IS THE LEGAL & CLAIMS HISTORY?

Because of the construction industry's litigious nature, pending judgments, claims, or suits may not be a clear indicator of potential problems with a prospective subcontractor; however, it is important to know if a subcontractor is regularly involved in lawsuits.

Ask your attorney to research this information. If a subcontractor has failed to complete jobs or has filed bankruptcy, then it is worth investigating. If a subcontractor is rebuilding from a bankruptcy, then the GC should make a conscious decision about taking on additional risk.

HOW IS THE SAFETY RECORD?

The importance of job safety cannot be overstated. In 2011, 17.5% of the 4,114 worker-related fatalities in private industry were construction-related.²

What Are the Benefits of Using Electronic Plan Rooms?

The industry as a whole continues to become more technologically savvy, and many GCs are using electronic plan rooms to increase efficiency. Using a central database to send requests for bid increases the pool of bidders by using the additional subcontractors listed with the bid room. This increases efficiency, brings new subcontractors into the process, and opens new doors for subcontractors – but increases risk.

Some subcontractors also use electronic plan rooms to extend their businesses into new types of construction and/or move into jurisdictions where they do not have previous experience.

Financial Checklist

- Net worth
- Cash balance
- A/R balance
- Current assets (A/R and cash)
- Current liabilities
- Working capital
- Debt balance
- Debt to equity ratio
- Line of credit/available balance
- Accrued warranty work
- Dollars in backlog
- CPA-prepared financial statements

Construction's "Fatal Four"

In 2011, the leading causes of worker deaths on construction sites were falls, followed by electrocution, struck by object, and caught-in/between. These "Fatal Four" were responsible for nearly three out of five (57%) construction worker deaths, according to the BLS. Eliminating the Fatal Four would save 410 workers' lives in America every year.

FALLS: 251 out of 721 total deaths in construction (35%)

ELECTROCUTIONS: 67 (9%)

STRUCK BY OBJECT: 73 (10%)

CAUGHT-IN/BETWEEN: 19 (3%)³



GCs are just as responsible for workplace safety as subcontractors. Per OSHA Standards 29 CFR §1926.16, *Rules of construction*:

(a) In no case shall the prime contractor be relieved of overall responsibility for compliance with the requirements of this part for all work to be performed under the contract . . . and . . . (d) Where joint responsibility exists, both the prime contractor and his subcontractor or subcontractors, regardless of tier, shall be considered subject to the enforcement provisions of the Act.

Subcontractors' safety programs have a direct effect on working conditions and OSHA compliance, and creating a safe working environment largely depends on subcontractors' policies and disciplined enforcement. For more on workplace safety, see the articles listed in Additional Resources at the end of this article.

A rate used for workers' comp, known as the experience modification rate (EMR), is a key indicator of the subcontractor safety experience. A GC's insurance agent can provide the average EMR for your region and type of construction. Generally speaking, an EMR of 1.0 is the baseline; a higher EMR indicates historical incidents, and a lower EMR reflects a positive track record with few or no reported incidents. An electronic search for OSHA violations by company is

available at www.osha.gov/pls/imis/establishment.html. In addition to the EMR, confirming a drug-free workplace insurance discount is an indicator that drug testing and continued enforcement exists.

WHAT IS THE SUBCONTRACTOR'S JOB EXPERIENCE?

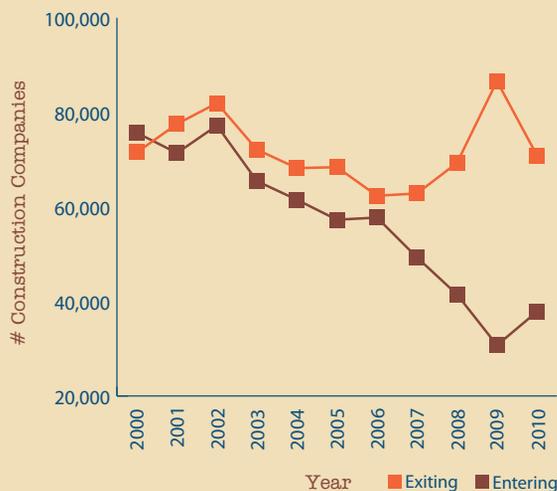
Historical questions about the geographic location of prior and current jobs will give an indication about a subcontractor's current area of expertise. Comparing job size can also be a good indicator of whether they have the resources to handle your job and take on additional work. If a job is taking longer than anticipated, it could be an indication that there is an issue on the job or a pending claim.

Do the References Check Out?

A reference check with prior GCs and major suppliers can help determine operational performance and financial stability. If a subcontractor does not regularly pay its suppliers on time, the suppliers can disrupt a job by stopping delivery and filing liens.

Although some GCs rely on cutting joint checks, this practice is not as secure as it used to be. The use of check cashing stores, electronic ATM deposits, and mobile phone deposits creates an environment of less scrutiny – and a check can

Construction Companies' Entry & Exit to Industry



Prequalification Options

The prequalification form at the end of this article is a sample of standard questions used when qualifying a subcontractor and can be used as a Microsoft Word document or electronic form sent out with a request to bid. There are also software and file room companies that provide automated, customizable methods to query subcontractors and provide results in a database format.

In addition to providing convenient and consistent ways to collect data, these types of software also provide a secure location for confidential and sensitive information. Some sureties will provide a service to collect the subcontractor information and perform the analytics, which some subcontractors prefer due to the sensitivity of the information.



be more easily deposited without the second endorsement. Certainly, a GC could eventually prove the check was incorrectly endorsed, but the time involved and proof required would create a true hardship and make funds more difficult to recover.

According to the U.S. Census Bureau through 2010, the construction industry had a business exit rate of 16.6%, which equates to 70,860 construction companies leaving the industry; since 2001, companies exiting have exceeded companies entering.⁴

Although subcontractors are prequalified when they bid the job, updating their information annually and maintaining an ongoing monitoring process can help identify potential difficulties. Regular reference checks can also foster a company-wide awareness for subcontractor stability, and contribute to overall project stability.

Once prequalified, a subcontractor can be added to a preferred qualified list for future reference. As new projects arise, the GC can use the information already submitted, and if it is more than a year old, require that the subcontractor update it.

Conclusion

When a GC awards a contract to a subcontractor, the GC has trusted its reputation with the subcontractor's ability to meet the schedule and perform with high-quality work within a contracted cost. This is a strategic and financial commitment that depends on the integrity of the subcontractor and its ability to perform. Current profit margins are slim enough without adding subcontractor failure.

CFMs can make a critical contribution by implementing a method to evaluate a subcontractor, establishing the selection criteria, and creating a process to implement the recommendations. The results could help reduce project delays, minimize penalties, decrease subcontractor failure, and directly contribute to the bottom line. ■

Endnotes:

1. Altman Contractors, Inc. Subcontractor Prequalification Form. Boca Raton, FL.
2. U.S. Department of Labor. Occupational Safety & Health Administration (OSHA) Commonly Used Statistics: Construction's "Fatal Four." www.osha.gov/oshstats/commonstats.html.
3. Ibid.
4. U.S. Census Bureau. Business Dynamics Statistics (BDS) Data Tables: Establishment Characteristics (by Sector). www2.census.gov/ces/bds/estab/bds_e_sic_release.xls.

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Susan has been a member of CFMA's South Florida Chapter since 2008 and served as a board member in 2010 and 2011. She is also a member of the AICPA. Susan earned a BS in Accounting from Arizona State University and a Masters in Accounting from Nova Southeastern University in Ft. Lauderdale, FL.

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On several occasions, Rich has testified on issues affecting contractors before Congress and before the IRS regarding proposed regulations.

A member of CFMA for more than 20 years, Rich is Chair of CFMA's Tax and Legislative Affairs Committee and a member of CFMA's Emerging Issues Committee. He is also a longtime author for *CFMA Building Profits*, a member of the South Florida Chapter, and a founding member of the Central PA Chapter. Rich is past Chair of ABC's National Tax Advisory Group.

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Website: www.shavell.net

Additional Resources

1. "Zero Injury: A Cultural Imperative for the Construction Industry" by Calvin E. Beyer & Eric Lambert – January/February 2013
2. "The High Cost of Noncompliance: Can Your Company Afford It?" by Eric P. Berezin & Antony L. Sanacory – September/October 2011
3. "90 Days to Transform Your Safety Culture" by Patricia Kagerer & Grace Gandarilla – September/October 2011



Don't Miss the Sample
Subcontractor Prequalification Form
BEGINNING ON THE NEXT PAGE





Sample Subcontractor Prequalification Form

Company Information

Company Name: _____

Street Address: _____

City, County: _____

State, Zip: _____

Primary Contact Name: _____ Title: _____

Phone: _____ Fax: _____

E-Mail: _____

Business Type – Ownership

Federal ID or SS#: _____ Number of Employees: _____

Check Business Type:

Partnership Year Started: _____ Type of Partnership: _____

General Partner: _____

Corporation Year Incorporated: _____ State Incorporated: _____

Officers: _____

Limited Liability Company Year Incorporated: _____ State Incorporated: _____

Managing Member: _____

CEO/President: _____

Sole Proprietor Year Organized: _____ Name of Owner: _____

Union or Nonunion

Does your company qualify for a Special Classification? Yes No

If yes, what type of classification:

Women-Owned Business Enterprise

Disadvantaged Business Enterprise

Minority Business Enterprise

Small Business Enterprise

Hub Zone

Veteran-Owned

Other:

Expiration Date: _____



Licenses

STATE	COUNTY	LICENSE #	CLASS/TYPE	EXP. DATE

Insurance

Does your company meet the attached minimum insurance requirements for Workers' Comp, General Liability, Auto, Completed Ops, and Additional Insured? Yes No

Attach a sample of your current Certificate of Insurance.

Bank/Financial

Name of Bank: _____

Address: _____

Contact Person: _____

Phone: _____ E-Mail: _____

Amount of Line of Credit: \$ _____ Current Line Available: \$ _____

Renewal Date: _____ Dun & Bradstreet No.: _____

Submission of financial statement is not required at this time. However, all contracts greater than \$500,000 will require financial statements (audited, reviewed, or compiled) prior to awarding the contract. This information will be handled confidentially.

Bonding/Surety Information

Bonding Company: _____ AM Best Rating: _____

Street Address: _____

City, State, Zip: _____

Contact: _____ Phone: _____

Fax: _____ E-Mail: _____

Bonding Rate: _____ %

Bonding Capacity:

Single Project Limit: \$ _____ Total Bonding Limit (Aggregate): \$ _____

Current Bonding Available: \$ _____

Attach letter from Surety or Surety Agent indicating single project and aggregate bonding capacity.



Claims/Past Performance

Has your organization failed to complete a contract in the past five years? Yes No

Is your organization involved in a bankruptcy or reorganization? Yes No

Are there any pending judgments, claims, or suits? Yes No

If yes to any of the above, please attach detail on a separate sheet.

Safety

Does your organization have a written safety program? Yes No

Does your organization have an Orientation Program for new hires? Yes No

Does your organization have a Hazard Communication Program? Yes No

Do you hold toolbox safety meetings? Yes No

In the previous three years, has your organization been cited for a serious (as defined by OSHA) violation? Yes No

Experience Modification Rate (EMR) and OSHA Recordable Incidents for the past three years:

YEAR	EMR	OSHA RECORDABLE INCIDENTS

Does your organization receive a discount from your insurance carrier as a Certified Drug-Free Workplace? Yes No

Recent Experience

List four of the most significant projects completed in the past five years:

PROJECT & LOCATION	OWNER	GENERAL CONTRACTOR	CONTRACT AMOUNT	DATE COMPLETED	CONTACT NAME & PHONE
1.					
2.					
3.					
4.					

List three of the most significant projects under construction:

PROJECT & LOCATION	OWNER	GENERAL CONTRACTOR	CONTRACT AMOUNT	AWARD DATE	CONTACT NAME & PHONE
1.					
2.					
3.					



Preferred Regions & States

REGION/COUNTY	STATE	REGION/COUNTY	STATE

CSI Codes/Trades

List trades performed by CSI Code:

CSI CODE	DESCRIPTION	CSI CODE	DESCRIPTION

References

List contact information for three major suppliers:

COMPANY	CONTACT	PHONE	FAX OR E-MAIL
1.			
2.			
3.			

List contact information for three owners, GCs, or construction managers the company has worked for within the past two years:

COMPANY	CONTACT	PHONE	FAX OR E-MAIL
1.			
2.			
3.			

Documents Attached:

- Sample of current Certificate of Insurance
- Surety letter
- Resumés of key project personnel, managers, project engineers, superintendents

The undersigned certifies that the information herein is true and sufficiently complete so as not to be misleading.

Completed by:

Name (please print)

Signature

Title (must be an owner or officer)

Date