Construction

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Mission critical

Prequalifying subcontractors important in today's economy

Subcontractor failure is one of the biggest risks faced by general contractors (GCs) today. And one of the most effective strategies for minimizing this risk is subcontractor prequalification. This process benefits subs, as well, by providing them with a competitive advantage once they've made the list.

Prequalification isn't new but, in the current economy, it's playing a more prominent role in the construction business. Many contractors are even using Web-based collaborative tools to help streamline the process.

Dangerous conditions

As you know, a distressed economy amplifies the risks associated with subcontractor failures. There are several reasons for this:

- Construction work is more difficult to come by, prompting some subcontractors to seek work outside their comfort zones (in terms of skill set, geographic location, financial resources and manpower).
- Most sureties have tightened their underwriting standards and reduced bonding capacity for subs.
- Credit lines and other forms of financing are more difficult to obtain.
- Subcontractor default insurance (SDI) may be less effective in bad times — a GC experiencing multiple subcontractor defaults in a single policy year, for example, can have significant financial exposure, even with SDI.

The best protection is a carefully developed subcontractor prequalification program. Sureties typically prequalify subcontractors for underwriting purposes, but an internal program is important for unbonded subs. Also, SDI providers generally require insured contractors to have a prequalification program in place.

Specific information

The prequalification process usually begins with a subcontractor's submission of a prequalification application or questionnaire, together with

financial statements and other documents (such as insurance certificates, safety records and licenses). After the GC reviews this information, it may wish to arrange a face-to-face meeting, check the sub's references and conduct other background checks.

The specific information required depends on the nature of the GC's business and the size and types of projects subcontractors will bid on. Typically, requirements include information about a sub's management team, experience and expertise, geographic reach, current and upcoming projects (to demonstrate capacity), past performance history (including any material litigation, claims or bankruptcies), safety record, and insurance coverage.

From a financial perspective, the GC should scrutinize the subcontractor's financial statements (or tax returns, if financial statements aren't available) to ensure that the sub has the financial strength and stability to handle the job. The GC should satisfy itself that, among other things, the subcontractor has a healthy amount of cash, a strong "current ratio" (current assets divided by current liabilities), and accounts receivable that are reasonable in comparison to income. It's also important to find out whether financial statements were prepared internally or by a CPA with construction industry experience.

The GC might want to develop a rating system. Whether subs are rated on a point scale or simply on a pass/fail basis, such a system can help speed decisions during the bidding process.

Web-based solutions

There are Web-based prequalification networks that offer significant benefits for GCs and subcontractors alike. From a sub's perspective, these networks are a big time-saver because the subcontractor enters its financial and other information only once (with periodic updates). Plus, the networks expose subs to many potential sources of new business within the network.

GCs benefit because the information is automatically routed to all relevant decision-makers, who can review the data and assign ratings. These ratings then become readily available for use in the bidding and award process.

One of the most important benefits of a Web-based network is its ability to automate the updating process. Whether updates are required once a year, every six months, quarterly or at some other interval, the system automatically generates reminder e-mails to the subcontractor. When the sub updates its information, the relevant personnel at the GC are alerted so they can revisit their ratings.

Prequalify, then requalify

Prequalification should be an ongoing process, not a one-time event. Even financially strong subcontractors are susceptible to the risks and uncertainties of the construction industry.

Subcontractor red flags could signal trouble

Here are some examples of red flags that may signal potential subcontractor failures or defaults:

- Reluctance to furnish or update financial statements or other requested information.
- Sloppy presentation of financials.
- Declining cash flow or liquidity.
- Increasing amounts of debt.
- Growth in accounts receivable while income declines.
- Insufficient working capital to meet backlog.
- Failure to comply with debt covenants.
- Denial of surety bonds.
- Increasing number of liens, claims or lawsuits.
- Escalating employee turnover.
- A pattern of profit fade.
- Difficulty in determining job status and cost to complete.
- Rising overhead.

It's critical for GCs to monitor subcontractor performance and require prequalified subs to "requalify" periodically. (See "Subcontractor red flags could signal trouble" above.) This process benefits subcontractors as well, because prequalification and requalification forces them to regularly take their own financial pulse. ■

Owner compensation: What's reasonable?

Controlling owners of closely held construction companies are generally free to set their own salaries and bonuses. But, under certain circumstances, the reasonableness of owner compensation can become an issue.

In a 2010 case, *Multi-Pak Corp. v. Commissioner*, the U.S. Tax Court outlined five factors to consider in determining whether a corporate shareholder/employee's compensation is reasonable.

Compensation matters

There are several situations in which the reasonableness of owner compensation might come into play. If a company is a C corporation, for example,

the IRS or a state taxing authority might challenge excessive owner salaries as an attempt to disguise nondeductible dividends as deductible wages.

If a company is an S corporation, the government may claim that it set unreasonably *low* salaries to avoid payroll taxes. S corporation shareholders aren't subject to self-employment taxes (the equivalent of payroll taxes for the self-employed) on their shares of corporate earnings. So there's a tax incentive to pay out earnings as distributions rather than salaries.

This isn't an issue for other types of entities, such as partnerships or LLCs. Their owners generally are subject to self-employment taxes on their shares of the entity's earnings, whether distributed to them or not.

If a company is an S corporation, the government may claim that it set unreasonably low *salaries to avoid payroll taxes.*

In a valuation context, it's often necessary to "normalize" owner compensation to a reasonable level to avoid distorting a company's true earning power. This may be an issue in divorce or other family law matters involving the value of a spouse's business interest.

The issue may also come up in situations requiring valuation of a company's stock (such as a merger or acquisition, equity or debt financing, shareholder dispute, or bankruptcy).

The 5 factor test

Courts take different approaches in determining whether a business owner's compensation is reasonable. Some have adopted a "multifactor" approach, considering anywhere from five to 12 factors in light of a company's particular facts and circumstances.

Other courts apply an "independent investor" test. Essentially, this test asks whether a hypothetical independent investor would be willing to pay the amount of compensation at issue.

In *Multi-Pak*, the Tax Court examined five factors in determining whether compensation paid to the corporation's sole shareholder and CEO (more than $2 million in 2002 and 2003) was reasonable:

1. The employee's role in the company, including position, duties, hours and general importance to the company's success.
2. Comparison of employee's compensation to compensation paid by comparable companies for comparable work.
3. The company's character and condition, including sales, net income or value, business complexity, and relative success in its industry.
4. Potential conflicts of interest — that is, does the employee's relationship with the company enable the business to disguise nondeductible dividends as deductible compensation?
5. Internal consistency of compensation policies and practices.

The Tax Court added an independent investor test to its conflict-of-interest analysis. The court explained that, "if the company's earnings on equity after payment of the compensation at

issue remain at a level that would satisfy a hypothetical independent investor, there is a strong indication that the employee is providing compensable services and that profits are not being siphoned out of the company disguised as salary."

Although factors 1, 3 and 5 above favored the company over the IRS, and factor 2 was neutral, the court's decision turned almost exclusively on the outcome of the independent investor test. It found that the CEO's 2002 compensation was reasonable: The company's 2.9% return on equity (ROE) for that year, though modest, would have satisfied an independent investor in light of the company's recent sales growth and its long-term potential.

In 2003, however, the ROE dropped to an unacceptable -15.8%. The court found that reasonable compensation for that year was just under $1.3 million — which was in line with the CEO's average compensation in previous years and would produce an ROE of 10%.

Do your own research

To anticipate potential issues with owner compensation, it's good to examine these factors when structuring compensation packages. By evaluating the five factors above, researching compensation surveys for your industry and estimating the impact of owner salaries on ROE, you can get a feel for what's reasonable and what's not. ■

Asking the right questions about your profitability

In today's economy, contractors must take any threat to their profitability seriously. Regularly asking the right questions about your profitability can help you keep your guard up. Here are a few to consider:

Are we ignoring overhead?

Expenses that aren't directly related to your projects, commonly referred to as "overhead" or "indirect costs," are easy to ignore. Examples of indirect costs include:

- Project management, purchasing, contract administration and safety oversight salaries,
- Small tool, fuel and supply, and freight charges,
- Appraisal, consulting, accounting and legal fees,
- Taxes, title transfers, permits, bonds and job insurance, and
- Shop and marketing costs.

Construction companies that fail to properly allocate indirect job costs to their projects are missing out on opportunities to recoup expenses and submit accurate bids.

When looking for ways to reduce these costs, consider your history. An analysis of your indirect costs and their relationship to your operating results, for instance, can help you determine which costs are fixed, which are variable and which are a little of both.

You probably can't do much to change fixed costs beyond, perhaps, negotiating with your lenders, landlords, utility providers, etc. But you may be able to trim variable costs by cutting out (or down on) unnecessary expenses.

Once you're armed with that knowledge, you can construct a budget for indirect costs to plan for the coming year. Then you can regularly compare your budgeted amounts for indirect costs with your actual spending. If you're going overbudget, look for ways to cut back.

Are we managing our ins and outs?

You do the work, you generate an invoice and you send it out. Bills come in and you pay them the best you can. The management of construction receivables and payables, however, is easily taken for granted.

One receivables strategy that plays well with many contractors is front loading contract billings. This involves shifting some profits into earlier phases rather than applying a flat rate to all phases as usual. Be careful not to be too aggressive, as overbilling can alienate your owner or general contractor, which can cause problems down the line. But, when done properly, this strategy can help you collect some of your profits before the retainer is paid on completion.

If you've always paid vendors within 30 days and are experiencing a cash flow shortage (easy to do in today's economy), consider extending your payment cycles. Just as you're sometimes flexible with parties that owe you money, ask for a break from your creditors to help you handle the cash crunch and deal with cost overruns.

Are we addressing change orders properly?

It's critical that you take the time needed to address change orders properly. Doing so can help protect and even bolster your bottom line in tough times. But, first, you need to know your contracts. It's next to impossible to quickly identify a change unless you know how it differs from the original agreement.

Also, be sure you have a well-managed change order system. Ultimately receiving a written, signed and authorized change order that will get you paid requires careful recordkeeping. Maintain daily reports, project correspondence, meeting minutes, schedules, cost records, photos and other documentation to help indicate an operational change.

If you've always paid vendors within 30 days and are experiencing a cash flow shortage, consider extending your payment cycles.

Last, be sure to provide written notice and an explanation of how your revised work will affect the schedule and delivery date, including a date on the document to prove you gave owners plenty of time to react to the associated costs. Lack of notice can be a strong defense for owners, so following these steps will help increase the likelihood you'll get paid for the extra work.

What else?

These are but a few informative queries that can help you monitor and, we hope, improve your profitability. Work with your financial advisor to figure out which questions to ask and how to find the correct answers. ■

Beware of the invisible contract clause

As the building industry continues to struggle, more and more contractors are taking on public construction projects — many for the first time. Public projects can be a lucrative source of new work, but contracting with federal and state government agencies requires careful planning.

One area in particular that demands careful due diligence is the public construction contract. Not only can these documents be lengthy and complex but, in some cases, "invisible" mandatory contract clauses may be treated as part of the contract even if they're not included.

Where it all started

Federal and state procurement regulations often mandate certain contract clauses for public projects. And if a government contracting officer omits such a clause — whether intentionally or inadvertently — it may nevertheless be incorporated into the contract under the "Christian Doctrine." This doctrine has nothing to do with religious studies. Its name comes from a 1963 U.S. Court of Claims case: *G.L. Christian and Associates v. U.S.*

Christian involved a large military housing project that was canceled after the Army deactivated the military base where the project was to be built. The government terminated the construction contract, even though it lacked a Termination for Convenience (TFC) clause as required by federal procurement regulations.

The contractor sued for breach of contract and sought to recover its anticipated profits. But the court rejected the plaintiff's lost profits claim, ruling that the mandatory TFC clause was a deemed term of the contract and that the plaintiff was presumed to be aware of it.

The Christian Doctrine doesn't apply to every mandatory contract clause. Subsequent cases (notably, the Federal Circuit's 1993 decision in *General Engineering & Machine Works v. O'Keefe*) clarify that the doctrine is limited to clauses that "express a significant or deeply ingrained strand of public procurement policy."

No promises

The lesson here for contractors is simple: If you're pursuing public projects, familiarize yourself with the Federal Acquisition Regulation (FAR) and other relevant federal and state regulations. The courts will assume that you're aware of all mandatory contract clauses and may read them into the contract even if they're not there.

Contracting officers have some flexibility to modify standard contract terms. But don't rely on informal promises. Be sure any deviations from the regulations are properly documented and that any necessary approvals have been obtained.

Public knowledge

FAR and other procurement regulations are complex and are subject to interpretation by the courts. So be sure to consult a knowledgeable construction attorney before you sign a public construction contract. ■