

From The Owner's Perspective: Identifying And Avoiding Financially Distressed Contractors

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In today's challenging economy, an owner starting a new project, or continuing an existing project, should give increased consideration to the contractor it hires to perform the work. Obviously, hiring a financially distressed contractor puts the owner at increased risk of not completing the project on time or on budget if the contractor goes out of business. This article discusses some of the preventative steps an owner can take to help avoid hiring a financially distressed contractor, and some proactive, protective steps an owner can take to minimize the impact to the project if the contractor becomes financially distressed during the project.^{1,2}

At The Onset, Cash Is King

A critical time to assess the financial strength of a contractor is before the contract is awarded. During the bidding process, the owner can require the contractor to provide its recent financial statements and other financial information. These can vary depending upon the size of the contractor, whether the contractor is public or private, and whether the company is audited by an accounting firm. Often times, private contractors have loans from banks that require the contractor to provide audited financial statements as part of the lending process. If no

¹ For the purposes of this article, we will consider the owner-general contractor relationship from the perspective of the owner. Similar considerations may be applicable to the general contractor-subcontractor or general contractor-vendor relationships.

² This article is not considered a comprehensive list of all recommended actions.

financial statements are available, the last two or three years of tax returns should be provided, at a minimum. The financial statements will help identify whether the contractor's short term financial position puts it at risk of cash shortfalls and possibly going out of business in the future. The following financial measures should not be the sole basis for assessing the financial strength of a contractor. Rather, these measures should be used in conjunction with sound business judgment and other considerations. Some of the information from the financial statements which can help assess the financial strength of a contractor include:

- **Cash On Hand:** One of the leading indicators of bankruptcy is the availability of cash and liquid assets, or the lack thereof. If the contractor has little to no cash on hand, this contractor has an increased risk of going out of business. However, the amount of cash and other short term assets needed to operate each company will vary.
- **Current Ratio:** The current ratio is calculated by dividing current assets by current liabilities. The current ratio is an indication of a company's ability to pay its short term liabilities, such as debt and accounts payable, using its short term assets, such as cash, inventory, and accounts receivable. A current ratio of less than one indicates that the company may be unable to pay its liabilities if they became due at that point in time. A ratio of less than one does not confirm a company will go bankrupt; however, it does indicate the company may have current cash

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flow issues and financial difficulties in the future.

- Debt To Asset Ratio: This is the ratio of total liabilities to total assets. This ratio shows the portion of the company's assets that are financed through some form of debt, whether short or long term. A ratio of less than 0.5 means that the company's assets are at least twice the amount of its debt. A debt to asset ratio that approaches one is an indication that the company has debt that is approaching or exceeding its assets. In challenging economic times, higher debt can put a strain on the financial stability of a company since more debt will need to be paid back or refinanced.
- Z-Score: The Altman Z-Score ("Z-Score") is an analytical measure that was developed in the late 1960's to help predict whether or not a company was likely to go bankrupt within the next two years. The measure is calculated using four different financial ratios, as follows:³

$$\begin{aligned} & 6.56 * (\text{working capital}/\text{total assets}) \\ + & 3.26 * (\text{retained earnings}/\text{total assets}) \\ + & 6.72 * (\text{earnings before interest and} \\ & \quad \text{taxes}/\text{total assets}) \\ + & \frac{1.05 * (\text{net worth}/\text{total liabilities})}{\text{Z-Score}} \\ = & \end{aligned}$$

The higher the Z-Score, the less likely the firm will go bankrupt in the next two years.

³ The Z-Score was originally calculated for predicting bankruptcies for manufacturing companies. Over the years, the Z-Score calculation has been modified for application in other industries as well. This calculation is for general use.

Similar to reviewing financial ratios, the Z-Score is not 100% accurate and should be carefully considered. Depending on the duration of the project, the Z-Score may need to be calculated periodically to determine if there has been a decline in the score. The Z-Score does not directly address the importance of positive cash flow from operations of the company. The Z-Score provides a quick check of the financial health of the company but should not be your only analysis.

Also, the owner should consider asking the contractor for financial information that may not be readily available in the financial statements provided. For example, the owner should understand the contractor's ability to obtain further financing if needed, when its current loans are due, and whether the contractor has significant past-due obligations. A review of the age of the contractor's outstanding accounts payable balance can also be important. If the age of its outstanding payments is increasing or exceptionally long, this can be an indication the contractor is having trouble paying its bills as they become due. Another area of inquiry and review is the contractor's accounts receivables. Large accounts receivables that have been outstanding for a long period of time can be a red flag, as can accounts receivables which include claims from other projects. In these instances, the owner should consider asking further questions to better understand the likelihood and timing of payment of these accounts receivable. Answers to these questions will help provide a more complete picture of the contractor's financial health.

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Understand The Contractor's Project And Firm History

The owner should also understand the contractor's project history before making the hiring decision. Is the contractor's historical work experience different from the project being bid? If so, the contractor may be reaching out of its expertise to make ends meet. Does the contractor have a history of litigation, arbitration, or claims against owners or bonding companies? If the contractor has had prior difficulty with payments to its subcontractors or suppliers, there may be a trail of litigation which helps identify financial distress. Has the contractor or its directors ever filed for bankruptcy? Questions like these will help the owner better understand the contractor's financial history and its ability to perform the work. Much of this information can be requested during the bidding process or through research.

Additional Information

If financial statements are not available, if the financial information provided by the contractor is not sufficient, or if the owner wants to double-check the accuracy of the data provided, a credit reporting company can provide information valuable to understanding the financial solvency of a company. For a fee, a credit bureau⁴ may provide a report with detailed credit information and payment history, key financial ratios, and other potentially relevant data.

Before Hiring, Contractually Protect The Owner

Ideally, the contractor will stay financially viable throughout the project and complete the work on time and on budget. However, the owner can establish

⁴ Such as Dun & Bradstreet or Experian.

contractual obligations which can help minimize the impact in the event the contractor does become financially distressed and cannot complete the project.

For example, the owner can contractually require the contractor to guarantee completion of the project and payment of its subcontractors and suppliers through payment and performance bonds.⁵ A payment bond provides assurance that the contractor will pay the obligated labor and material costs to its subcontractors and suppliers. A performance bond guarantees the contractor will complete the project satisfactorily. If the contractor does not meet one or both of these obligations, the surety company guaranteeing the contractor's work should provide compensation up to the bond amount. If a contractor is unable to secure the appropriate level of bonding for the project, this may be an indication of financial difficulties or the contractor's past performance.

The contractual termination for default clause may include language which would allow the owner to terminate the contractor if it does not meet its payment and performance obligations in a defined timely manner. Without this language, it may be more difficult for the owner to remove a contractor that has not met its obligations and may be headed towards financial distress and possibly bankruptcy.

Continued insight into the contractor's financial position during the project can help the owner identify troubling trends before problems arise. The owner can

⁵ In the United States, the Miller Act requires a performance bond and a labor and material payment bond on federal construction projects greater than \$100,000.

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contractually require the contractor to provide updated financial statements throughout the project.

Additionally, credit reporting agencies can provide notification of changes in a contractor's credit risk. With this information, the owner may be able to determine whether the contractor is heading towards financial difficulty and perhaps bankruptcy before the affects are felt on the project, and can try to mitigate the potential impacts to the project.

Bankruptcy Appears To Be Coming – Now What?

Ideally, the owner and contractor can identify a potential for financial distress and bankruptcy early. If so, the owner can try to work with the contractor to improve its financial position and stay in business through project completion. If not, early notification of financial distress can help the owner position itself to minimize the impact of a potential work stoppage.

If the contractor stops work or is about to stop work due to bankruptcy, the owner should contact its attorney to consider its options, including pursuit of some or all of the protective methods mentioned above (e.g., bonds, termination). Additionally, the owner should track the cost and schedule impact of the work stoppage. The owner may be able to recover these impact costs from the contractor or the surety.

Conclusion

Analyzing the financial health of a contractor in these difficult economic times before a contract is awarded can help prevent a potential impact to the owner and its construction project. On longer-term projects, continued due diligence and analyses can provide early warning signs of financial distress. Remember

cash and other short term assets are critical to keeping a contractor solvent. Financial statement analysis can assist in evaluating the ongoing financial health of your contractor and can provide some early warning signs of potential financial difficulties or stress.

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