

Sage Construction and Real Estate

Job Ready Guide

Reduce Your Construction Risks
Managing the Complexities of Subcontractor Compliance

By Leslie Shiner and Deb Carpenter-Beck



Who Has Time for Compliance?

When you're rushing to get your subcontractors on the job to stay on schedule, the last thing you're thinking about is paperwork. You don't have time to worry about whether your subs have valid workers' compensation or liability insurance. Your first priority is to start the job and keep it moving. However, the contractor/subcontractor relationship is critical to secure and produce profitable jobs.

The rules and regulations are becoming stricter and the financial impact greater for contractors who don't pay enough attention to subcontractor compliance issues and processes. Consider these factors:

- Government compliance audits in the construction industry are on the rise.
- Auditors now have online access to resources such as the State License Board to determine if your subs are properly licensed and insured, catching violations more easily.
- Insurance companies don't want to pay any more than they have to on claims and are tightening their rules to reduce their own risk.
- Surety agents are looking beyond financials to consider and analyze how well you run your business, including how you manage subcontractors and suppliers.

In this Job Ready guide we'll discuss practical ways to reduce your subcontractor compliance risk and help you be more confident that you have the processes in place to protect your business.

Ignoring the importance of compliance is like driving without a seat belt. Odds are, it isn't going to make any difference, except for that one time when it does.

Prequalification

An important first step in assuring compliance is the prequalification of subcontractors. It also helps evaluate potential subcontractors to ensure they can perform at a level that meets your expectations and reduces the risk of situations that can lead to compliance investigations.

Prequalification can be handled in a number of different ways, including using a prequalification questionnaire, a request for qualifications, or a qualifications statement. No matter which process you use, keep these factors in mind:

Experience: Make sure the subcontractor has the right experience, including volume of work and average job size. Will your jobs be a stretch or a step down for a contractor who just wants to keep a crew busy? Matching the sub's capabilities to your requirements will help assure your jobs get the resources and attention they deserve.

Accountability: Understand the subcontractor's supervisory structure. Find out who runs the business and who manages the workers on the job site. Verify that the sub's structure supports your needs for prompt decision making, compliance, and issue resolution.

Business Management: Assure that it is a well-run business. Depending on the job size, consider requesting an audited or reviewed financial statement and look it over carefully for any warning signs. Confirm that the subcontractor has the appropriate bonding capacity and insurance (for certain size jobs, bonding requirements may include performance bonds). Ask whether it has ever declared bankruptcy or worked under a company that has declared bankruptcy.

Litigation: Check whether the subcontractor has a history of litigation, claims, or conflict resolution. This step is critical to reducing your risk from a compliance perspective.

Processes: Ask how the sub handles labor time capture and reporting (for certified payroll) as well as other processes that will affect its compliance in areas that put you at risk.

Safety: Look into the company's safety record. What type of safety training programs does it have in place? Has it received any safety awards?

Reputation: Do a simple Google search to uncover feedback on the company, keeping in mind the credibility of the sources. While an Internet search may provide useful information, don't forget to also ask for tried-and-true references from other contractors, material suppliers, and banks.

Prequalification doesn't eliminate the need to regularly monitor subcontractor compliance during the course of the job, but it's a proactive way to assure that the subcontractors you use are also compliance minded.

Key Areas of Compliance

A few years ago it was rare for a contractor to be audited by a government agency; now it is common-place. In 2011, agencies such as the Department of Homeland Security, the Department of Labor, and the Internal Revenue Service began collaborating to find violations in industries that historically had higher noncompliance rates. Construction was one of those industries.

Today any indication of mismanagement noticed by one agency can trigger another agency's audit of you and your subs. State agencies have also increased their compliance efforts. Governmental focus along with annual insurance audits and owner-requested construction reviews are putting compliance at the forefront of issues for contractors.

When working with subs, three compliance areas present the largest risk for your company:

Uninsured Workers on the Job Site

Most states and construction contracts require contractors to carry valid workers' compensation insurance. And according to many state laws, the GC is liable for paying workers' compensation benefits if an uninsured sub's employee is injured on your job.

Your workers' compensation risk doesn't stop there. During your insurance audit, you must also prove that your subcontractors are fully insured. If your subcontractor does not carry insurance or has let it lapse, the sub's payroll can be added to your subject wages, resulting in significantly higher premiums.

In either scenario, you could easily be on the hook for thousands of dollars in insurance payments that should have been your sub's responsibility. And certainly those payments were not included in your estimated job costs.

Lien Waiver Requirements

Anything can happen on a job site, and when it involves a legal claim, that's when you need to make sure you don't shoulder all the responsibility. To protect yourself, you need to know when, where, and why lien waivers are required. And you should make it a practice to only pay subcontractors once they have provided the correct signed lien waiver. While the lien waiver paperwork may be complicated, not providing the correct signed waivers to your client can delay or even prevent partial or final payment for the work you do.

There are basically four types of lien documents:

- **Conditional Waiver and Release Upon Progress Payment**—Used when the subcontractor has submitted an invoice for a portion of the work on a job, but has not been paid.
- **Unconditional Waiver and Release Upon Progress Payment**—Signed as the subcontractor is paid for a portion of the work on the job. Waives the lien rights for that portion of the work.
- **Conditional Waiver and Release Upon Final Payment**—Used when the subcontractor's work is complete and a final bill has been submitted. Once this has been signed, the contractor can release the final payment.
- **Unconditional Waiver and Release Upon Final Payment**—Releases all claimant rights to a lien through a specific date unconditionally.

Also, in some states you or your subcontractor may be required to file a preliminary lien notice before work begins to establish the right to file a lien. The dates of these notices vary by state, so it is crucial to know the specific lien laws in your state. Missing the deadline by just one day can remove the lien rights altogether.

And, if you take on work in another state, don't assume you will be protected with your current lien compliance process. Lien laws differ significantly state by state and even between projects depending on if it is a private, state, or federal job. Check with an attorney or mechanics lien service to clearly understand the differences in lien laws.

Certified Payroll

When you're working on public works projects, it is your responsibility to collect and submit a weekly certified payroll report for all workers, including subs, on the job. Whether audited by the Department of Labor for federal projects or a state agency, this is another area of compliance that is increasingly under scrutiny.

Certified payroll reports insure that your payroll records, as well as those of your subcontractors, accurately reflect the hours worked, rate of pay (both base rate and fringe benefits), and work classification. Failure to produce certified reports can result in stiff fines. The risk of noncompliance is even higher because there is no statute of limitations on the certified payroll requirements as outlined in the Davis-Bacon Act.

Assuring your subs have proper certified reporting in place and basing your payments on their submittal of a certified payroll report will help you stay in compliance.

Six Tips for Success

1. **Create a culture of compliance.** Make sure your team understands the importance of compliance and the negative impact on the company if violations occur. To be successful, support for compliance initiatives must start with the executive team. Do not let your project managers or superintendents overrule the accounting department's decision to not pay a subcontractor if all of the required documents have not been received.
2. **Understand the rules.** Work with an attorney or compliance expert to stay on top of the latest regulations. Check in for compliance advice at least annually.
3. **Establish an automated process.** Keeping on top of today's compliance requirements is virtually impossible if you are handling the paperwork manually. Develop a process that automates as many steps as possible, including ways to prevent paying subs before you receive proof of insurance, lien waivers, and certified payroll reports. Other compliance processes to automate include permits, licenses, warranties, and close-out documents.
4. **Integrate your project management and accounting systems.** Communication between your accounts payable department and project managers is critical to compliance. For example, if your accounts payable system is not synchronized with project management, an accounts payable clerk may not be aware that a job is a public works project and could pay a sub prior to receiving necessary certified payroll reports.
5. **Monitor compliance daily.** For added protection, set up an automated alert that warns you of subcontractor compliance problems, such as an expired workers' compensation or liability insurance. Today's advanced construction software systems offer this type of capability.
6. **Conduct your own audit.** Why wait for a formal audit? Once you've set up your compliance process, conduct a random spot check of the process every three to four months. Too often contractors assume a process is working just because it's in place. A random audit helps you easily spot problems and correct them before they put your company at risk.

Independent Contractor or Employee?

Correct worker classification is key to compliance. But it isn't always clear whether someone should be considered an independent contractor or an employee. Especially if you are looking at individuals who have contractor licenses, it may seem better to hire them as subs to save money on employee taxes and workers' compensation. However, if they do not fit the criteria of an independent contractor, you can be at risk of fines, penalties, and additional payroll taxes.

The following three criteria provide a simple first check to determine if someone would be viewed as a contractor in the eyes of the IRS. Use these and other IRS guidelines to save yourself audit and back-payment headaches.

To be considered subcontractors, individuals must:

Be paid by the job, not by the hour. This shows that they are taking responsibility for their own profit and loss.

Not manage others in your company. Contractors must be seen as independent entities and not working *in* your company.

Set their hours and price; supply their own tools and materials. Contractors make their own decisions on how work should be done.

The Internal Revenue Service and Department of Labor are increasing their enforcement of worker classification rules. For more information about contractor vs. employee classification, visit this [IRS site](#).

Summary

As a contractor, one of your jobs is to keep your subs in compliance. This responsibility is becoming more important every year as regulators tighten their enforcement. Understanding compliance requirements, creating an automated process, and spot checking to assure nothing is falling through the cracks can reduce the burden of compliance for your team. It will also save you considerable time, money, and energy down the road by preventing noncompliance issues.

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