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Critical Considerations for Complex Insurance Programs

As contractors seek ways to control costs and increase profit margins, they are more frequently looking to complex insurance programs. Although contractors that adopt such programs assume more risk, they also stand to reap a greater reward if projects proceed as planned.

But, as the name indicates, these programs bring numerous considerations that generally do not arise with traditional insurance coverage. Contractors must understand all of the implications – including the significantly different accounting required and impact on financial statements – before they enter into such programs.

Types of Complex Insurance Programs

Currently, the most common programs are high-deductible or self-insured retention (SIR) plans, contractor controlled insurance programs (CCIPs), subcontractor default insurance (SDI), and captive insurance programs.

High-Deductible Plans

With a high-deductible plan, the contractor generally pays a premium for coverage above and beyond the plan's deductible. The amount of the premium can be based on a variety of factors, including the contractor's payroll dollars by class of employee, total revenue, or subcontractor billings. The insurance policy comes with annual and per-claim out-of-pocket limits.

Contractor Controlled Insurance Programs

A CCIP is controlled by the GC and usually includes workers' comp and/or general liability coverage. A CCIP consolidates all of the insurance risk on a project, so subcontractors do not use their internal insurance policies, thus shifting the risk from the subcontractors to the GC. A CCIP is set up with an underwriter, and the coverage and administration can be purchased for a single project or a rolling-project program (i.e., a block of coverage for multiple projects).

Subcontractor Default Insurance

SDI protects the GC and project owner from additional costs and losses due to a subcontractor's failure to complete a

project – usually when a subcontractor declares bankruptcy or is unable to execute the contracted work for any reason. SDI comprises two components – the self-retained limit (the contractor will cover any costs up to a specified amount) and the fixed insurance charge or premium (the insurer pays for costs beyond a deductible).

Captive Insurance

A captive insurance company is a separate entity that is usually wholly owned and controlled by the insured or owners of the insured. Captive insurance can encompass a wide variety of coverage, including workers' comp, general liability, and automobile.

A captive can be set up in a number of different structures, all of which are separate from the insured, including:

- Single parent captive – The captive provides coverage for a single contractor. Single parent captives often elect IRC § 831(b), which allows it to only pay tax on the investment income during years in which premiums fall under certain thresholds (\$2.2 million beginning in 2017).
- Group captive – Multiple contractors use the same captive, usually resulting in lower rates than available to a single contractor.

Accounting for Complex Insurance Programs

When contractors take on more responsibility for the insurance process, the accounting becomes more complicated than that of traditional insurance programs. The proper accounting steps will vary depending on the type of program.

High-Deductible Plans

Under a high-deductible plan, the contractor must consider two main components that affect their financial statements. First, a contractor with a high-deductible plan must accrue premiums based on its actual payroll cost or sales volume while making payments according to a periodic schedule. This generally creates a discrepancy between the amounts paid and amounts accrued, which will appear as a prepaid or accrued insurance liability on the contractor's balance sheet.

Second, the contractor should set up a loss reserve account for actual claims. The contractor must accrue a liability for loss reserves based on known claims and claims incurred but not reported (IBNR). The loss reserve for known claims will be driven from a third-party administrator report, which provides actual costs incurred and estimated costs not yet incurred on reported claims.

The contractor can use its claims report to help determine the appropriate loss reserves, but it must develop a strong knowledge of the third-party administrator's reporting and estimating policy and compare estimates with actuals to better estimate the current claim reserve.

The contractor should evaluate and consider adjusting the third-party administrator's estimate based on its understanding

of the claim's circumstances and historical accuracy of the third-party administrator's estimates. The IBNR is based on the contractor's claim history and typical lag period before a claim is reported. When analyzing and accruing for the known claims and the IBNR, loss reserve estimates should reflect whether the contractor expects to come in under or over the per-claim and annual deductibles.

In certain circumstances, actuarial reports based on industry-specific historical figures, assumptions, and projections might provide useful guidance when calculating reserves.

CCIPs

Rather than charging the owner for third-party insurance premiums, a contractor with a CCIP will charge for the insurance risk that the contractor is retaining. Within a CCIP, a contractor should begin to charge each job for a premium when the job starts as an accrued CCIP insurance liability. The premium charged to the owner and job costs is typically a predetermined rate calculated as a percentage of the contract amount.

To account for the premiums, the contractor will debit job cost on the income statement and credit a liability for insurance revenue or the loss fund. The contractor will then use the insurance liability created as a cost center liability for all of the insurance costs throughout the project, including paid and accrued claims, insurance costs (e.g., reinsurance premiums and agent fees), safety costs (e.g., training and supplies), administrative costs (e.g., bank and third-party administrator fees), and contingency or unknown costs.

If a contractor becomes aware that the CCIP program will operate at a loss, then the CCIP losses should be recognized as soon as they are known.

Excess premiums over costs are eventually recognized as income. Depending on the types of coverage included in the CCIP, the contractor will need to determine the exposure period (i.e., how long the contractor will be exposed to workers' comp or general liability claims). The income from a CCIP's proper execution will be recognized over the exposure period. Regardless of whether this determination is based on history or actuarial reports, the process must be methodical and reasonable.

The contractor must also account for the potential effect on the percentage of completion (POC) calculation. Some contractors apply the predetermined rate to the entire contract and charge that amount as an expense on the first day of the contract, but that approach will improperly accelerate

Evolution of Complex Insurance Programs

Historically, most contractors shifted project risk associated to an insurance provider or other third party – using what's known as traditional full-risk coverage.

When profit margins on construction projects stagnated, though, contractors began to see the potential advantages in assuming a share of the risk themselves, relying on outside providers only for protection from a higher level of liability and managing the resulting premium savings accordingly.

These changes have led to the more widespread use of various complex insurance programs. The programs can be established for all types of insurance coverage, including:

- Workers' comp
- General liability
- Health
- Excess/umbrella liability
- Builders' risk
- Pollution liability
- Professional liability
- Automobile



revenue recognition. If the impact of the accelerated revenue recognition is material, then adjustments will be required.

SDI

A contractor that uses SDI will initially debit the job cost on the income statement and credit a liability on the balance sheet based on a predetermined rate. The liability represents two distinct items.

First, amounts are owed to an underwriter for the premiums related to the coverage over the high-deductible amount. Upon remitting the premiums to the underwriter, the contractor will credit cash and debit the initial liability. Second, the contractor has a liability for future claims under the large deductible amount.

Often, the contractor provides cash to the underwriter for this purpose, and the underwriter sets up an escrow account and holds the contractor's cash until the exposure period of the potential future claims has expired. Since the contractor does not have the authority over the escrow account, the company will credit cash and debit a receivable from the underwriter.

If the contractor is successful in its SDI program, then its claims will be limited, the second portion of the liability will become future income, and it will be refunded the balances held in escrow by the underwriter.

Claims below the contractor's deductible are charged to the SDI loss reserve if the balance is sufficient; if not, then the contractor accrues for the additional loss as soon as it is known and charges the income statement accordingly in the period the loss is recognized.

As the SDI exposure period expires, the contractor will recognize any amounts collected in excess of claims paid – amortizing or charging to insurance income accordingly. It must scrutinize the appropriate exposure period – which varies by jurisdiction – and the historical or industry claim trends. It can use an actuarial report or other methodical approach.

Like a CCIP, SDI can affect the POC calculation. Charging the predetermined rate on the entire contract at the beginning could have a material impact that requires subsequent adjustment.

Captive Insurance

Because a captive insurance company must satisfy regulators' reserve requirements, a contractor might put a significant

amount of cash into it, stripping out some of the contractor's own equity. Therefore, the contractor will need to determine how the captive's financial information will affect its financial statements.

Depending on the structure and setup of the program, the captive's financial information might be required to be consolidated or combined with the contractor's financial statements. When that occurs, the contractor must take steps to ensure that it does not duplicate premiums and reserves. Bear in mind that the captive is required to undergo audits, and the corporate audit statement must not contradict the audit results for the captive.

It's important that contractors determine the state of domicile for the captive to ensure compliance with the applicable insurance regulations. Contractors also must be aware of the additional costs that come with captive arrangements, including those for the required audit, taxes on insurance companies, legal fees, and a third-party administrator to handle claims.

Internal Controls & Financial Management

Contractors would be wise to institute certain internal processes and controls when approaching these complex programs. Additionally, several other financial concerns should be considered when evaluating, implementing, and operating these types of programs. Some of these are common to the four types of programs under discussion, while others are program-specific.

Common Considerations

Claims & Exposures Management

Regardless of the program type, a contractor will need to develop processes and procedures for managing its claims and liability exposures.

One vital step is to regularly review claims (with the third-party administrator or insurer, if applicable) to verify accuracy and appropriate reserves. Contractors also should determine when they will release aging claims and the related reserves, as third-party administrators often take a conservative stance when it comes such claims.

Internal Supervision & Administration

It's essential that responsibility for an insurance program not be added to the duties of an employee with an already full plate (e.g., the CFO or CEO). Consider assigning the process to a risk manager. Designating ownership of the process is especially critical for contractors with SDI, CCIPs, and captives, as the person in charge must assume responsibilities of a

third-party insurer in addition to the usual internal supervision and administration.

Reserve-Level Projections & Effect on Financial Statements

As they rise and fall, an insurance program's loss reserves will affect the contractor's financial position. Contractors, therefore, must have a handle on the likely movement of the reserves when making financial statement projections. Financial statement preparers should consult with the program administrator to develop insurance claim projections or confirm that their projections are reasonable.

Cash Flow Considerations

Contractors with complex insurance programs might have significant cash outflows at times due to paying premiums, providing cash for escrow, or funding specific claims. Additionally, significant cash inflows are received from customers when the insurance is billed on the project or cash is returned through the release of escrowed funds. Accordingly, these cash inflows and outflows must be considered for cash flow management and projection purposes.

Additionally, a contractor using a captive might have a large outflow for the initial capitalization since captives must satisfy minimum funding requirements. The contractor could need to make additional cash transfers to maintain compliance with the funding requirements throughout the program's life that could eventually be returned to the contractor through distributions resulting from overfunding or captive operating results.

Letter of Credit Requirements

Just as insurance regulators require insurance companies to maintain cash reserves to cover claims, the third-party insurers involved in complex insurance programs typically require contractors to set aside an escrow account or secure a letter of credit in the amount of the contractors' exposure under the specific program.

For a high-deductible plan, for example, the insurer would require a letter of credit that is estimated to cover expected losses below the deductible amounts.

For a contractor with a CCIP or captive, the underwriters for any insurers covering amounts beyond the contractor's aggregate liability will want a letter of credit to support the contractor's ability to pay for risks retained by the contractor. When a contractor has SDI, the letter of credit could cover the self-insured retention and the deductible if an escrow account is not set up.

Deductible Limits

Every contractor must determine its risk appetite. How much can a contractor afford to pay out if an insured event occurs? How much cash flow will be required? Does the contractor have sufficient borrowing capacity to cover any shortfalls?

CCIP-Specific Considerations

Owner Reluctance

One potential roadblock for CCIPs can occur if owners view such programs unfavorably or question their quality and reliability. Contractors must be prepared to explain the advantages of the program for the owner and be ready to negotiate pricing. Most owners, for example, will want to see how the contractor's price compares with that of traditional insurers.

Safety Management

Safety management is, of course, part of any construction project's risk management, regardless of the insurance program in place. But it takes paramount position when a contractor adopts a CCIP. The contractor should assign an employee (or employees) to see that its jobs are meeting all of the applicable safety standards to minimize accidents and, in turn, claims and payouts.

Contract Agreements

Contractors will need to tweak their contracts with subcontractors and owners to include specific language related to the CCIP.

SDI-Specific Considerations

SDI implicates some of the same considerations as CCIPs, including owner reluctance and contract agreement language.

In addition, a contractor with SDI will need a robust subcontractor prequalification program focused on financial and operational health because the contractor assumes the risk that the subcontractors will not fail.

Contractors should also go beyond one-time prequalification for their subcontractors; regular monitoring of subcontractors' ongoing health is key.

Captive-Specific Considerations

Contractors should be aware of the impact of captives on their working capital if the companies don't consolidate their financial statements. The captive could be sitting on a substantial amount of cash that will not appear on the contractor's financial statements, thereby reducing its working capital. This could significantly affect the bonding capacity of



an organization. The contractor could also find that shifting money into its captive hurts its own valuation.

Proceed with Caution

Complex insurance programs can provide a contractor with numerous advantages, but they also present more complications than traditional third-party insurance – including the impact on a contractor’s financial statements.

To maximize such programs, a contractor must lay a solid foundation with adequate planning. ■

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