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A NEWSLETTER FOR THE CONSTRUCTION INDUSTRY

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What Interests a Surety Company Most?



Whether you need to establish a bond for the first time, maintain an existing surety line or increase capacity, it's important to understand which indicators surety underwriters monitor most closely.

1. Liquidity and working capital. A surety wants to know a contractor can finish a job, and it knows the best candidates are those with solid, well-balanced assets.

High net worth alone isn't enough. A road builder can have plenty of equipment but be weak in working capital.

Working capital means current assets — cash, current receivables and some inventory, rather than property and equipment not easily liquidated — minus liabilities. Expect a surety to discount prepaid expenses, shareholder receivables and a third or more of inventory. The surety expects the best, but it plans for the worst — and it wants your assets ready if it must come after them.

2. Cash flow. Most contractor job defaults, and thus most surety losses, are the result of weak cash flow. To increase bonding capacity, maximize your cash on hand and establish a strong line of credit with a lender.

Sureties often calculate free cash flow as net income plus depreciation,

Bonding requirements, once found mainly in federal contracts, are becoming more widespread. Fortunately, surety companies have begun to rebound from several years of losses and have relaxed their criteria somewhat. But they will continue to require significant financial discipline.

Unlike a lender, which is concerned about a borrower's overall stability, a bonding company focuses closely on specific jobs. It wants assurance that a job is on course, both in time and gross margin. To a surety, a contractor's job schedule is often as important as its overall financial statement.

Regular job schedules normally include: original estimates; actual billings, costs and revenue recognized to date; percentage of completion; and costs and profits in excess of billings.

More Immigration Compliance Rules to Come



As the U.S. immigration debate unfolds, employers will encounter further efforts to saddle them with more responsibility on the issue.

The Association of General Contractors, along with other organizations, is lobbying against the idea of employers as government enforcers. But while specific legislation may pass or fail, and federal agency rules come and go, the near-term trend is clear: Employers are facing more stringent requirements, with civil and even criminal penalties for failing to comply.

Activity in Statehouses

After the Congressional failure to enact immigration reform in 2007, a variety of state initiatives have gotten underway. Initially such efforts were promoted mainly by conservative lawmakers, but the current crop has broader support. And the new laws are drafted more carefully to withstand constitutional challenges.

One widespread debate revolves around forcing employers to confirm the legal work status of their employees using the federal government's E-Verify database. Don't look for consistency, though –

an Illinois law makes it illegal after January 1, 2008, for companies to consult the database at all.

Some of the penalties in effect or under debate for employers who hire unauthorized aliens include:

- Daily cash fines
- Suspension or revocation of business licenses
- Ineligibility for state, local or federal contracts
- A new exposure to lawsuits from employees displaced by such hiring

ICE, Social Security and No-Match Letters

Employers presently meet federal verification requirements by having each new hire complete an I-9 form and furnishing supporting documents. An employer who knowingly hires someone not authorized to work in the U.S. is subject to penalties.

In September 2007, Immigration and Customs Enforcement (ICE) issued a "Final Rule" to clarify its intentions on enforcing these laws.

But did an employer knowingly hire an illegal alien? The new ICE rule covers both actual knowledge and constructive knowledge – a reference to information an employer (in ICE's view) should have known. The rule adds examples of constructive knowledge, including an employer's receipt of:

- a Social Security Administration (SSA) no-match letter;
- a Department of Homeland Security no-match letter; or
- a request to sponsor an employee for a work permit.

The most likely of these events, an SSA no-match letter, advises an employer that one or more of its employees are using names and social security numbers that don't match the agency's records. Every year the SSA sends out letters listing several million such workers.

Safe Harbor

Noncompliance can bring fines up to \$11,000 per hire, disqualification from federal contracts and criminal prosecution.

However, the SSA has no enforcement power, nor can it give ICE the names of no-match employees or employers. Meanwhile, the ICE rule itself includes a safe harbor provision that defines constructive knowledge much more narrowly.

To qualify for safe harbor, employers must meet a timetable that begins with receipt of an SSA no-match letter. Within 30 days the employer must check its records and notify the SSA of errors.

Within 90 days, if the SSA has not closed the matter, the employer must ask the no-match employee to contact the SSA to resolve the issue and attempt to reverify the match with the SSA using additional documentation.

Day 93 is the final deadline. If the no-match issue hasn't been resolved, the employer must obtain photographic and other documentation of the employee's identity and work status – excluding materials that use the suspect social security number. If these measures fail to verify the employee's work authorization, the employer must terminate the employee.

amortization and other non-cash items, minus principal payments on debt. Too low a figure – especially if the contractor is carrying high debt – will reduce bonding capacity.

3. Work-in-process (WIP). A surety wants to see steady work, accurately tracked and estimated – not wide swings of gain or fade. Profit fade indicates the contractor overestimated WIP, recognized revenue too early and will face the shortfall sooner or later. Profit gain is not as troublesome, but still reflects badly on a contractor's ability to provide accurate estimates.

4. Overbillings and underbillings. Some overbilling is acceptable, but too much can mean a struggling contractor is borrowing from one job to fund another. A surety knows that deficit that will show up eventually.

Underbillings can indicate poor management. A contractor that has not billed an owner for completed work may have overprojected gross profit. When underbillings reach 25 percent of working capital, be prepared to explain why.

5. Backlog expressed as a percentage of overhead indicates whether a contractor has enough other work on hand to pay its expenses.

6. Change orders and claims. After a big change order, it's tempting to recognize big revenue. But if the owner disputes the extent of the order or says he never approved it, profit fade may loom ahead. Too many claims can be a red flag, too. Is the contractor recognizing income prematurely from claims against the owner? Or is the contractor itself a

frequent target of claims? Sureties aren't looking to bond companies with a history of problems.

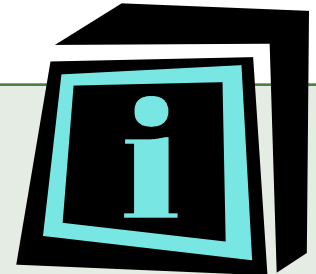
Tips for Strengthening Bonding Capacity

- Break down large jobs. A surety that balks at a large contract may be more willing to write bonds for a series of smaller jobs. Contracts can often be broken down in this way without affecting a contractor's profits.
- A joint venture can help some contractors increase their own surety limits by leveraging the strength of another larger company.
- Find the right surety. Look for a bonder whose clients include companies similar to your own, and understand which metrics and ratios it considers most important.
- Communicate. Set regular meetings

and deliver a clear stream of reports. If trouble appears, speak up. The surety understands that problems occur in construction, but it wants the facts early, not as a last-minute surprise. And don't talk just with the local agent, but get to know the home office as well.

Strengthening a company's bonding capacity can be complicated. Contractors should assemble a strong team – a lender, a lawyer and an accountant who all understand the surety market and can provide the contractor with sound advice.

In meetings with a surety, an accountant can explain tax strategy and financial planning and give the surety greater confidence. For more information contact Vito Loisi at 630-545-4554.



Resources on Surety Bonds

For more information and support, contact the following sources:

Surety Information Office (<http://sio.org>) – The SIO is the industry's information source.

Surety Association of America (<http://surety.org>) – The companies that write most U.S. bonds belong to this trade association.

National Association of Surety Bond Producers (<http://nasbp.org>) – The NASBP is the international organization of professional surety producers and brokers.

U.S. Small Business Administration (<http://sba.gov>) – The SBA guarantees some bonds, which can lead a surety company to increase a contractor's limits.



Construction Briefs

In Construction Fraud, Greed Meets Creativity

Our new series on fraud in the construction business leads off with a sampling of recent schemes. Unlike recent high-profile corporate frauds, in which misleading financial statements deceived investors, most construction frauds target contractors themselves.

Over-purchasing – The spike in copper prices led a project manager and a bookkeeper to order more tubing than was needed. They sold half to a scrap yard for cash, and the bookkeeper made sure the vendor's invoice was paid without fuss. The two felons later moved into steel, paint and even topsoil.

Kickback schemes – Price hikes can tempt suppliers to offer kickbacks or other incentives. When a clerk put out RFQs for cement, one vendor offered her not only a

percentage of every order she sent his way, but also a better paying job at his own company if she could swing a long-term contract.

Diversion – Some fraudsters steal by the hour. The excavator didn't know its D9 bulldozer was moonlighting four nights a week, rented out by a foreman. When the bulldozer ripped a gas main on the second site, the explosion destroyed the machine and left the excavator facing a lawsuit.

Credit card scams – When a project manager gave himself a raise by using the company credit card for his own retail purchases,

neither he nor the company knew two other PMs were doing the same thing.

Rigged bids – In an old-fashioned conspiracy, four big HVAC contractors were dividing a market among themselves. On each new project, three would quote high and a GC would hire the designated "low" bidder, thinking it had leveraged free-market competition.

In our series, we'll look at the types of errors that permit such schemes to succeed – and show you how contractors can protect their assets. ■

Our firm can help you fraud-proof your business. To learn more contact Joel Dziedzic at 630-545-4508.

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Illinois Department of Labor Employee Classification Act

Signed into law last summer, and effective January 1, 2008, this new act addresses the practice of contractors misclassifying workers as independent contractors. The act provides specific criteria to determine status and significant penalties for violators. For a summary of the act, contact Gina Riberto at 630-545-4556 or gina.riberto@wolfco-fs.com.

More Immigration Compliance Rules to Come

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What To Do Now

As a first step, draft a uniform notification to employees identified in an SSA no-match letter. Train HR staff on the safe harbor, the timetable and reverification procedures. Audit I-9 forms and hiring procedures and documentation, and consider enrolling in E-Verify, state law permitting.

The SSA's no-match letter warns employers not to fire anyone solely because of the letter. Immigration compliance procedures, like others, must be performed consistently across the workforce.

If you'd like more help with immigration compliance, our firm can help you find the expertise. Please contact us for more information.