

# THE BOTTOM LINE

Atlantic Coverage Corp.

*Esuretyhand.com*

EXCELLENCE IN SURETY BONDS

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## The Hardening Surety Market

For the past 5+ years Contractors have enjoyed what is known as a "Soft Market" within the Surety Industry. A Soft Market is considered to be a time when underwriting criteria and the providing of surety credit to contractors is easier to obtain. This normally happens during good economic times. Profitability within the Insurance (Surety) Carriers and their Reinsurance Companies, competition among surety Carriers, and continued growth in the construction industry encouraged this phenomena. In recent years our industry has enjoyed such a time and Contractors have benefited with increased surety limits, both single and aggregate, relaxed indemnity requirements, reduced premium rates on surety bonds and, most notably, relaxed underwriting requirements. Relatively speaking, in such a market almost any contractor could obtain what is considered a sizable surety bond line compared to the financial strength and experience exhibited by the contractor.

In contrast a "Hard Market" (the opposite of a Soft Market) occurs when competition among Surety Carriers is limited, losses occur and the Surety Carriers' reinsurance markets start to show losses within their books. As a result, reinsurance (insurance for losses among the Surety Carriers) costs increase and the demand for more "control" within the underwriting guidelines is introduced once again. This is where the contractors start hearing about Working Capital and Net Worth ratios not being sufficient for that "one stretch project" or there is insufficient working capital to sustain the two additional projects the contractor wants to bid, etc....

After a long stretch of experiencing a Soft Market, the Bonding Industry is now entering into a Hard Market and contractors of all sizes should take note. Some of the major reasons why our industry is moving this way are as follows. There is a reduced competition

among Surety Companies. In the past year or so the Surety Industry has seen increased mergers causing the number of companies providing surety credit to decrease. Losses within the industry are increasing. In fact two of the larger specialty markets handling small to mid size contractors have lost their A.M. Best "A" ratings due to losses. Without "A" rated bond paper it is hard to have your bonds accepted by many owners. Reinsurance losses go hand in hand with Surety losses. Sureties pay reinsurance companies to share the losses they might incur. For example, if a Surety Company had a loss of \$1MM it might only take a hit for \$200M while the reinsurance company or companies absorb the remainder of the loss. Part of the premium you pay your bond company goes towards this "Surety Insurance Coverage". Just like car insurance premiums, the more losses incurred the more the Surety's pay for this insurance.

As a bonded contractor what can you do to protect yourself? First and foremost is to understand the surety companies requirements. In recent times many sureties have overlooked late information, or in the heat of competition waived some information normally required in the underwriting process such as timely Corporate Fiscal Year-End or interim financial statements, Work in Progress reports, personal financial statements, bank line of credit information, etc. In a hard market, the bonding company will require this information prior to approving any sizable single bond or aggregate backlog levels. Let your agent know if any sizable projects, or projects with a different scope of work are of interest to you. Make sure you provide timely financial information. Please don't convince yourself that because you have not had any problems with losses the hard market won't affect you.

Bond underwriters obtain underwriting criteria from their home offices. The home office does not normally visit contractors, so it is easy

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### "Famous Quotes"

*It is easier to ask  
for forgiveness  
later than permis-  
sion now."*

*Carl Zorn Jr.*

*"Genius begins  
great works, labor  
alone finishes  
them."*

*Joseph Joubert*

*"Our greatest  
glory is not in  
never failing but in  
rising up every  
time we fail."*

*Ralph Waldo Emerson*

*"The future be-  
longs to those who  
believe in the  
beauty of their  
dreams."*

*Eleanor Roosevelt*

*"Start by doing  
what is necessary,  
then do what is  
possible, and sud-  
denly you are do-  
ing the impossi-  
ble."*

*St. Francis of Assisi*

## The Tax Man Cometh: IRS Audits and the Construction Industry

*"The greatest thing in the world is not so much where we stand as in what direction we are going."*

*Oliver Wendell Holmes*

*"The reason a lot of people do not recognize opportunity is because it usually goes around wearing overalls looking like hard work."*

*Thomas A. Edison*

*"Someday is not a day of the week."*

*Anonymous*

*"You can't push anyone up the ladder unless he is willing to climb himself."*

*Andrew Carnegie*

*"No one can make you feel inferior without your consent."*

*Eleanor Roosevelt*

*"Pay no attention to what the critics say. A statue has never been erected in honor of a critic."*

*Jean Sibelius*

*"Do not seek to follow in the footsteps of the men of old; seek what they sought."*

*Matsuo Basho*

An IRS audit can put a lot of stress in an already stress-filled construction business. Compliance with federal income tax laws is based on a system of self-assessment. Think about it – we complete the income tax returns and send it to the IRS. Only certain information is sent independently to the IRS to be put through a database matching program. Therefore, the IRS uses the auditing of tax returns as an enforcement device to promote voluntary compliance with the tax laws.

It is quite often that we hear of celebrities being prosecuted for tax evasion in the months of February and March. Is this just a coincidence, or is this a well-conceived plan to possibly cause other taxpayers to re-think their own tax strategies?

The IRS, like most other businesses, has limited time and resources with which to operate. As such, they tend to focus their audits to those cases that will generate the most additional revenue for the US Treasury. The last report that we saw stated that the IRS was auditing something in the area of 2.2% of corporate returns. Individual returns were close to 1%. This relatively small percentage leads many taxpayers to play the 'audit lottery'. That is, rolling the dice hoping that your return is not one of the unlucky few selected. As you can probably guess, we are not big proponents of the 'audit lottery'. We prefer to approach any situation with a plan. Plus, we feel there is a value that must be placed on being able to sleep at night.

It is important to note that IRS auditors are more educated in the construction arena than in years past. Construction is a specialized industry. To assist the agents, the IRS publishes construction industry audit guidelines in a market segment analysis. It identifies the common tax issues that face a construction firm. This report indicates what the IRS agent should look for and how certain issues should be resolved.

This report can be found at the IRS web site at [www.irs.gov](http://www.irs.gov). Click on "Tax Info for Business". Then click on "Market Segment Specialization Program Audit Techniques Guides" ("MSSP"). In the "Guides" section, you will find categories such as "Construction Industry", "Architects", "Masonry and Concrete Industry", "Carpentry/Framing", and "Drywallers" to name a few.

The MSSP on the Construction Industry is a 161 page document. It is important that you and your CPA know what the IRS is looking for

so that you can plan accordingly.

One area that has been receiving a lot of IRS attention is the contractor's method of accounting for recognizing income from construction contracts. The IRS will focus on whether or not the correct method is being used. For example, there are significant risks for contractors that utilize the cash method for revenue recognition. A major concern is their level of inventory. If it exceeds a particular percentage of total revenues, the IRS may force a conversion to accrual. Even if a contractor does not carry inventory per se, the fact that it regularly orders material for projects to be installed at a later date could be construed by the IRS as having income-producing inventory. This could eliminate the cash basis as an acceptable method, forcing a conversion to the accrual method.

In addition, the contractor must not exceed certain revenue thresholds in order to remain on the cash method of revenue recognition for tax purposes.

Kleinrock's Federal Tax Bulletin reported in their April 17, 2000 edition that the Tax Court handed taxpayers a victory in this area in *RACMP Enterprises, Inc. v. Commissioner*. In this case, the Court held that a contract to provide labor and materials to a real property developer is a contract to provide a service, and the materials used by the developer are an indispensable and inseparable part of the provision of that service. The decision is very important to contractors where the IRS is aggressively looking to force the conversion of revenue recognition methods from cash to accrual. Please discuss this case with your tax advisor for specifics of how this ruling may or may not apply to your firm's situation.

It is critical that if the taxpayer does not have a solid basis for being on the cash method of revenue recognition for tax purposes, that the taxpayer apply for the change in accounting method. Do not have the IRS initiate the audit and change it for you. By voluntarily initiating the change, the taxpayer may be able to spread the tax liability over a four-year period. If the IRS does it, no such luck. The taxes are due immediately, plus interest and penalties may be assessed.

The CFMA magazine "Building Profits" published what we think was a very good article on this subject in the May/June 1999 issue. If you would like a copy, please contact our office.

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## The Tax Man Cometh: IRS Audits and the Construction Industry

Another 'hot' area concerns the classification of Independent Contractors. IRS agents look closely at this category to determine if these people are actually employees. Certain tests are applied. If the independent contractor status is denied, finding instead that the individuals are indeed employees, significant taxes, interest and penalties may be assessed.

Even the US Supreme Court has stated that a taxpayer is under no obligation to pay more than their share of the tax burden. There is, however, a difference between tax deferral and tax evasion. Be sure not to cross that line.

What should you do? Planning is the best

sleep insurance, in our opinion. Make sure that you have the right CPA on your team. There is no substitute for good advice brought to you by a professional that specializes in your industry. Plus, make sure that you maintain adequate, well-documented records (contracts, requisitions, payroll records, certificates of insurance from independent contractors, T&E expense reports, etc.).

We would like to extend our gratitude to Mr. Stephen D. Ebinger, CPA, Partner of Marden, Harrison & Kreuter, CPA's, PC for his input on this topic.

## The Hardening Surety Market

for the bond company to set parameters that look good on paper and ask the field underwriters to support such criteria. Remember that these underwriting guidelines come from recent statistical data surety companies and reinsurance companies have compiled from recent losses. In a hard market Bond companies are playing a "Prevent Defense". They are looking to prevent any future losses and will to err on the side of conservatism. However if you provide the bond companies information that establishes a comfort level with your firm and bond companies will work with you.

In a Hard Market you can still get the bonding you deserve. You need to spend a bit more time in the office compiling financial information, but it would be well worth it.

With the bond companies more diligent in

their underwriting efforts the contractors deserving of bonding will continue to obtain bonds while those competitors who did not deserve such levels of credit will find it increasingly difficult to get bonds. While things are tightening up in the surety bond market, construction forecasts still remain positive for the next year or two. For a determined contractor, a hard surety market could be the answer to finally finding projects with decent profit margins. Surety companies will start weeding out your competition for you on public works. It will be up to you to decide if you want to improve your financial reporting package for the surety company and take advantage of a situation where QUALITY contractors will have the opportunity to rise to the top. Good Luck!

## Methods of Preparations of Fiscal Year-End Statements

- Compilation:** The least informative of the three. Basically all the accountant does is take the information provided by the bookkeeper and present it in a statement form.
- Review:** Accountant receives the information from bookkeeper and proceeds to perform some background checks to verify accuracy of information. Depend on the accountant, a review statement could be as poor as a Compilation or almost as accurate as an audit.
- Audit:** All information, from bank balance, receivable collection, inventory etc... is inspected for accuracy. This is very time consuming and pricey as oppose to a review or compilation.

## Visit Our Web Sites

For construction & commercial surety bonds  
For computer networking / consulting  
For website design

[www.esuretybond.com](http://www.esuretybond.com)  
[www.alltechcreative.com](http://www.alltechcreative.com)  
[www.lifewebdesign.com](http://www.lifewebdesign.com)

*"Man does not live by words alone, despite the fact that sometimes he has to eat them."*

*Adlai E. Stevenson*

*"Half the world is composed of people who have something to say and can't, and the other half have nothing to say and keep on saying it."*

*Robert Frost*

*"Take time to deliberate; but when the time for action arrives, stop thinking and go in."*

*Andrew Jackson*

*"The valuable person in any business is the individual who can and will cooperate with others."*

*Elbert Hubbard*

*"I want this team to win, I'm obsessed with winning, with discipline, with achieving. That's what this country's all about."*

*George Steinbrenner*

*"Behold the turtle. He makes progress only when he sticks his neck out."*

*James Bryant Conant*

## **Best Wishes for a Happy, Healthy and Prosperous 2001 From All of Us at Atlantic Coverage Corp.**

### **Can We Help Someone You Know With Their Bonding?**

If you think we can help someone you know with their bonding needs, please call us at (516) 682-5000. These referrals fuel Atlantic Coverage Corp.'s growth and success.

Thanks to the referrals by our valued clients and friends, ACC continues to experience strong growth in 2000.

### **Company News**

Louis J. Spina, President of Atlantic Coverage Corp. and Scott Brackenbury, Contract Manager for Safeco Surety, gave a ninety minute presentation to the New York State Society of Certified Public Accountants Construction & Real Estate Committee. The presentation provided the CPAs with a comprehensive understanding of the surety products and marketplace. The topics included the basics of suretyship, specific obligations of the various surety bond products, current state of the marketplace, the changes in the marketplace that have occurred over the last two decades, underwriting process, claims process, disadvantages of alternative products and technological issues facing the industry.

Anthony Panno, Executive Vice-President of Atlantic Coverage Corp. joined the Little Village Golf Committee. This year's golf outing will be held on June 4, 2001 at the Tam O'Shanter Club. For more than 31 years Little Village School has been providing the finest in educational services to children with developmental disabilities at no cost to the families. For information regarding Little Village, please feel free to call us at (516) 682-5000.

### **Letter from the Editorial Staff**

This newsletter is designed with our readers in mind. All inquires and ideas regarding this or future newsletters are appreciated. Please send all inquires to me at [anthony@esuretybond.com](mailto:anthony@esuretybond.com). If you know anyone who you feel would like a copy of our newsletter, please let us know so that we can include them in our mailing list.

Continued success,  
Anthony M. Spina

### **Disclosure**

The Bottom Line is published quarterly by Atlantic Coverage Corp., 6800 Jericho Tpke., Suite 212E, Syosset, NY 11791. Telephone (516) 682-5000. A service for our clients, contacts and friends, it is meant to provide useful business information and practical advice and encourage its readers to keep up with all the latest developments. These articles are not intended to provide a complete discussion of the subjects presented. Because each situation is unique, we advise you to contact us before acting upon any of the following information or planning ideas contained in this newsletter. Any questions you might have about any topics mentioned in this newsletter, please contact our office.

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