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Member of the  
Wolf Financial Group

# Construction

Better Ways ▲ Better Results

A NEWSLETTER FOR THE CONSTRUCTION INDUSTRY

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## Internal Controls Keep A Ship Tight

Recent business scandals and legislation have focused attention on the role of strong internal controls in deterring fraud in large public corporations.

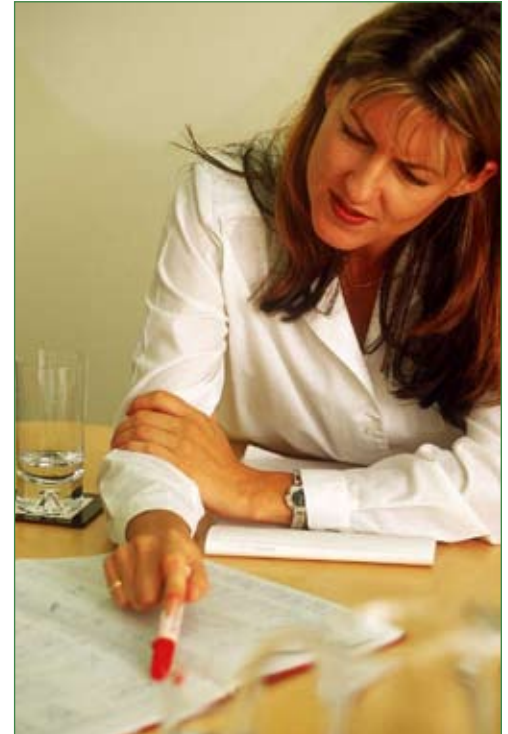
Controls are valuable for contractors too — not only to prevent fraud but also to improve operational efficiency and reduce unnecessary day-to-day losses. For some companies, internal controls can lead to a significant increase in profit.

“There are different types of controls,” says Joel Dzedzic, partner and member of the *Construction Services Group* at Wolf & Company LLP, “but most revolve around a few central principles. These include segregation of duties, multiple approvals for transactions and cross-checking of documents.”

### Losses from Error

Money slips through cracks on construction jobs. A carpenter pays an invoice for more expensive wood than was actually delivered. Another invoice omits a promised discount. A third invoice is correct, but is paid twice.

Meanwhile, two framing employees draw duplicate checks, and a mountain of sheetrock sits untouched for a year. There’s no malevolence at work in these losses — just old-fashioned error. Contractors may not notice such leakage, particularly in busy times, but ultimately it takes cash from their pockets.



### Losses from Fraud

Laurie the bookkeeper never took time off until the flu forced her out for a week. During her absence a co-worker came across a check made out to an oddly named vendor he’d never heard of. An investigation revealed that Laurie had set up several fake vendors, and over several years had paid them (that is, paid herself) more than a hundred thousand dollars.

Theft of materials is a particular danger in construction. Work is performed at remote locations, purchasing authority is spread widely and some materials are difficult to estimate precisely both before and after use.

## Save on Taxes By Trading Up

Normally, when a construction contractor sells vehicles, equipment or real estate, profits on the sale are subject to the capital gains tax.

But Section 1031 of the Internal Revenue Code offers to defer such taxes to a future time – if the seller reinvests the proceeds from the sale in other property of “like kind.” First enacted nearly a century ago and strengthened in 1991, the rule recognizes that the seller’s profits, in exchanges of equal value, only exist on paper. Specifically, the code provides that “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”

### More Than a Simple Swap

It’s possible that a buyer and seller could actually exchange properties, but that’s not how a like-kind exchange normally works. Here’s a more typical example.

Acme Excavation finds a buyer for three backhoes. But rather than accept payment, Acme engages qualified intermediary, or QI, to manage the transaction. The buyer takes possession of the backhoes, but transfers the proceeds to the QI instead of Acme.

Now Acme has 45 days to identify another like-kind property and 180 days to close a deal on that property. When Acme is ready to buy new backhoes, it doesn’t pay the seller – the QI does, using the proceeds it is holding from Acme’s earlier sale. Acme’s capital gains tax on its sale are deferred. Most 1031 transactions are more complex. The IRS code specifies which kinds of property are eligible and how exchanges must

be structured. And as similar as properties may be, they rarely have the same value. The IRS taxes the difference in value.

### What Is “Like Kind”?

“Like kind” refers to the purpose for which a property is held, and the IRS reserves like-kind exchange benefits for properties “held for productive use in a trade or business or for investment.”

Virtually all real estate, if held for one or the other of these purposes, is defined as like-kind. That means Acme can sell its back lot and qualify for Section 1031 if it uses the proceeds to buy a new shop building. For personal property, the IRS defines like-kind more restrictively, requiring that the two properties fall into the same asset or product class. In order to qualify for Section 1031, Acme should use the returns on its backhoe sale for other backhoes or similar earthmoving machines.

### “Boot” and Other Limitations

If the value of Acme’s purchase is less than the value of its sale, the difference is subject to capital gains tax. Although the IRS doesn’t use the term, this difference is widely known as the “boot.”

Further, if a seller receives any proceeds from the first sale before the exchange is completed, the entire transaction is disqualified under Section 1031.

Time is of the essence in a like-kind exchange. From the time the seller transfers ownership of the first property, two clocks are ticking. One is the 45 days allowed the seller to identify replacement property, and either buy it or deliver a detailed legal description to the QI. A second ticking clock requires the seller to close on the replacement property



within 180 days. This period ends, however, on the due date for federal tax returns – so after a late-year 1031 exchange, a seller should always file for an automatic extension.

### The Deferred Tax Benefit

A Section 1031 exchange essentially provides a tax-free loan from the IRS. Although taxes will eventually be levied on profits, the delay gives a contractor money to reinvest without penalty. Individuals are not limited in the number of 1031 exchanges they can transact, and there is no minimum price level.

Further, the accumulating tax liability is essentially forgiven at death, under the IRS’s method of calculating appreciation of 1031 assets passed on to heirs. ■

*With the help of an experienced and qualified intermediary, a like-kind exchange is easily available to contractors. For more information please contact Vito Loisi at 630-545-4554.*

So a project manager builds an addition to his kitchen, a plumber sells copper pipe for scrap, a framing crew chief operates a renovation business on the side — and all three enterprises are supplied by pilfering from their employer's inventory.

Some capers are discovered long after the fact, but others are never exposed. The heists add up over time, but each is inconspicuous in itself. And often the perpetrators are able to hide their tracks, especially if the contractor isn't tracking job costs closely.

### Preventable Losses

Cross-checks could have avoided some of these losses. When paid invoices are compared with delivery receipts and purchase orders, or time clocks with payroll records, these documents can reveal errors and deliberate manipulation.

Segregating duties can also prevent losses. In our examples, however, duties were combined. The person setting up new vendors was the same person who approved invoices and drafted checks. The PM who ordered kitchen tile also received it, distributed it and tracked tile costs. A hands-off ownership style makes shenanigans easy. An owner who's more involved might review these transactions, as long as the business remains small. But it becomes more difficult as the business grows.

Contractors tend to have weaker internal controls than companies in other industries. Owners often start out keeping the books themselves, and even after they hire a bookkeeper they stay close to the process. But then, as their business grows — larger labor force, more equipment, bigger bids — they keep the same small accounting staff.

If such contractors hire qualified people to perform those tasks, and also put strong controls in place, Can be more confident. They'll know that no invoice is paid without multiple approvals, that receipts are checked against bank deposits — and that these and other checks are performed as a matter of course by different employees.

### Getting Help With Internal Controls

An accountant can help contractors set up new controls or test systems already in place. Testing is important, because even though management may believe controls exist, actual practice can vary. "Yeah, we're supposed to do that ... but it's just too detailed. We've never actually done it." For that reason, today's standards recommend that consultants not simply ask about controls and

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## Controls for Contractors: A Sampling

Following are some internal controls that contractors can use to improve operating efficiency and deter fraud.

- Check estimates for accuracy of calculations, labor rates and correspondence with drawings.
- Compare job-cost estimates with actual costs. Require approvals for adjustments to costs or transfers of costs between jobs.
- Require that materials estimates above a specified amount include quotes from two or more vendors. Make purchases only with pre-numbered purchase orders, and map them to both receiving reports and invoices before payment is made.
- Check vendor invoices against estimates to ensure proper discounts and pricing.
- Make onsite communications refer to specific job numbers, phase codes or work order numbers. Obtain ink or electronic signatures on change orders before work begins, and revise contract values accordingly.
- Ensure that site conditions at variance with expectations are documented and forwarded to the home office immediately.
- Pay bonuses only on completed contracts, not work-in-progress.
- Record equipment usage weekly, and assign and expense maintenance costs as they occur.
- Review billings for timeliness, accuracy, conformity with contract terms and correct customer information.
- Reconcile billings are monthly with general ledgers and record under- and overbillings.
- Prepare financial statements monthly and support them with ledgers, bank statements and loan schedules.



# Construction Briefs

## Anatomy of a Fraud Ring

Tom the project manager started out small, ordering an extra spool of conduit and selling it at a scrap yard. The job came in under budget, so nobody really knew or cared how much conduit was actually in the walls.

Next came a big office building, and Tom's ambition grew. With copper prices climbing steadily, he hauled most of the job's pipe to the scrap man. The building would run fine on cheap PVC, which Tom bought out of his own pocket. When the contractor's engineer signed the as-built drawings, they never knew the liability they faced.

The contractor was grateful when Tom brought in Ruth the

bookkeeper. She had a head for numbers and construction materials too.

With Ruth paying the invoices, Tom expanded. Before long every third tank of fuel wound up in his back yard, along with a few tons of concrete. He couldn't move that much topsoil, but he knew a man downstate who could. Ruth found a trucker who'd split deliveries without a fuss.

They focused in the field, where most construction fraud takes place. They concentrated on hard-to-measure materials — piping, fuel, concrete, soil, wiring. With those, it's hard to know what actually ends up in the job.

Early on, Tom exercised authority to order, purchase and receive materials without oversight. His employer might have solved that problem by adding approval requirements. But later, who would have approved Tom's orders? Ruth?

Ryan the summer hire noticed something amiss. Tom and Ruth offered to bring him into the fraud ring, but Ryan's honesty surprised them and the game was up. The contractor wished he could press charges but he couldn't stomach a scandal, so he sent them on their way. Maybe you'll meet them some day. ■

*Thieves take the path of least resistance, so resist. Our firm can help you protect your hard-earned assets.*

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*Certified Public Accountants*

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Wolf Financial Group

## Internal Controls Keep a Tight Ship

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document the answers, but actually walk through transactions alongside employees.

### Necessary But Not Sufficient

Internal controls can minimize leakage and deter fraud. Like burglars who avoid houses with barking dogs, fraudsters are less inclined to pilfer companies whose transactions are automatically scrutinized by others.

However, controls may not stop determined thieves, particularly

those who work as a team. When two employees discover a common interest — one in purchasing, one in payables — they may be able to circumvent a control. Still, a systematic approach to internal controls can make a contractor far less vulnerable. ■

*Our firm can help you identify areas where internal controls can improve your operations. For more information contact Joel Dzedzic at 630-545-4508.*