Summer 2017

CONSTRUCTION INDUSTRY ADVISOR

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Consider a different route

4 accounting alternatives that may reduce financial reporting costs

Many privately held construction companies prepare audited financial statements that comply with Generally Accepted Accounting Principles (GAAP) as established by the Financial Accounting Standards Board (FASB). They do so, at least in part, to satisfy the requirements of lenders, sureties and other business partners.

Many of GAAP's requirements benefit private businesses and their financial statement users. But, for some contractors, the limited value doesn't justify the additional cost and complexity. Recognizing this, the FASB's parent organization, the Financial Accounting Foundation, established the Private Company Council (PCC) in 2012. The PCC's mission is to recommend exceptions or modifications to GAAP that respond to the needs of private companies.

So far, the PCC has recommended four FASB-accepted accounting alternatives that private construction businesses may use to ease the burden of complying with GAAP. Let's take a look at each one.

1. Accounting for certain leasing arrangements

Construction companies often set up separate leasing entities to accomplish a variety of tax planning, estate planning and risk management purposes. These entities, which typically have an ownership structure identical or similar to that of the construction business itself, hold equipment or real estate and lease it back to the contractor.

Ordinarily, GAAP may require the two entities to be consolidated for financial reporting purposes, a costly and time-consuming process that adds little value to the financial statements. But Accounting Standards Update (ASU) No. 2014-07 permits private companies to opt out of consolidation if the following requirements are met:

- The construction company and leasing company are under common control.
- The construction business has a lease arrangement with the leasing company.
- Substantially all activities between the contractor and the leasing company are related to leasing activities.
- If the construction company guarantees or provides collateral for any obligation of the leasing company related to a leased asset, the principal amount of the obligation doesn't exceed the value of the leased asset.

If the leasing company isn't consolidated, its revenues and expenses won't appear on the contractor's income statement, nor will its assets and liabilities appear on the balance sheet of the construction business.

2. Accounting for goodwill

Construction companies involved in acquisitions or other business combinations may acquire goodwill, which is the excess of the purchase price over the fair value of the identifiable assets acquired and liabilities

assumed. Under GAAP, acquired goodwill must be tested annually for impairment — a complex, costly and time-consuming process — and written down only if its fair value has dropped below its carrying amount.

To ease the burden on private companies, the FASB issued ASU 2014-02. It gives them the option of amortizing acquired goodwill over a period of 10 years or less and testing goodwill for impairment (using a simplified analysis) only if there's a "triggering event," such as an economic downturn, which is likely to cause an impairment.

3. Accounting for other intangibles

GAAP also requires companies involved in business combinations to identify and separately account for acquired intangible assets other than goodwill — also a potentially complex, costly and time-consuming process.

Under ASU 2014-18, private businesses may elect not to separately recognize certain intangible assets and to simply include them in goodwill. This accounting alternative applies to noncompetition agreements, as well as customer-related intangible assets that cannot be sold or licensed independently of other assets (such as nontransferable contracts or customer relationships). Note that, to take advantage of this accounting alternative, the company must also elect to amortize goodwill under the preceding alternative.

4. Interest rate swaps

Smaller construction businesses often have trouble qualifying for fixed-rate loans. To avoid the uncertainty associated with variable-rate loans, some contractors enter into interest rate swap agreements that effectively convert them into fixed-rate loans. Ordinarily, these arrangements are subject to complex hedge accounting rules but, in ASU 2014-03, the FASB offered a simplified option for private companies other than financial institutions.

This alternative essentially permits a company to account for an arrangement as if it had obtained a fixed-rate loan directly rather than a variable-rate loan and an interest rate swap. To qualify for this treatment, a swap agreement must satisfy several criteria, but most are "plain vanilla" swaps — that is, those designed solely to convert variable-rate loans into fixed-rate loans.

Ask the right questions when reviewing accounting methods

Every construction company should review its accounting methods periodically to identify opportunities to improve financial reporting, reduce costs and better manage tax liability. Examples of questions to ask as part of such a review include:

- Do we qualify for the cash method of accounting? If so, would it provide advantages over the accrual method?
- Are we using the most advantageous method of accounting for inventory? Long-term contracts? Retainage? Expensing, depreciating or capitalizing fixed or operating assets?
- Do we qualify for simplified accounting alternatives for private companies?
- Are we making the most of underused tax credits, such as the research credit and the domestic production activities deduction?
- Are we timing the deduction of accrued bonuses properly?
- Do we qualify for deferred recognition of advance payments?

Evaluate the impact

Contractors should consider using private company accounting alternatives to simplify their financial reporting and reduce their expenses. But if you're contemplating one or more of these options, consult your CPA to evaluate the potential impact on loan covenants and other business relationships. Also, run it by your lenders and surety to ensure an alternative accounting method is acceptable to them. ■

Waivers of subrogation: Are you really protected?

It's common for a construction contract to contain a "waiver of subrogation" provision under "insurance requirements." Unfortunately, these provisions are widely misunderstood. Although they're designed to shield owners, contractors and subcontractors against lawsuits by insurers covering project-related claims, the protection offered may not be as extensive as you might think.

Understanding the concept

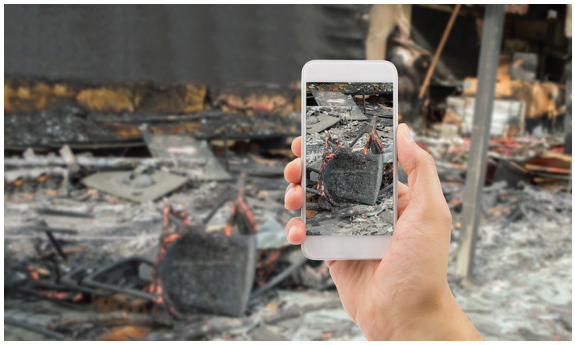
Subrogation is a legal concept under which an insurance company that covers a loss gains the right to "step into the shoes" of the insured. The insurer becomes "subrogated to" the rights of the insured, allowing it to sue any third party or parties allegedly responsible for the loss.

> *The breadth of protection depends on the terms of the parties' insurance policies and applicable law.*

Suppose, for example, that an owner hires a contractor to build an office building. During construction, an electrical subcontractor causes a fire that does $3 million in damage to the building. If the owner's property insurance or builder's risk policy pays for the loss, the insurance company becomes subrogated to the owner's rights and may sue the subcontractor for the damage it caused to the building.

Waiving the provision

The rationale behind waiver of subrogation is that the parties to a construction contract pay substantial premiums to buy insurance to protect



themselves against certain risks. If an insurer pays a claim, the argument goes, it should bear the loss and not be permitted to pass it on to another party. Otherwise, insurance companies would rarely pay for anything. Another benefit of waiver of subrogation is that it avoids costly litigation that can result if an insurer goes after one or more parties to the contract.

For these reasons, most standard construction contracts, including the American Institute of Architects form documents, contain waiver of subrogation provisions. Typically, under these provisions, parties waive all rights against each other for damages caused by fire or other perils to the extent such damages are covered by builder's risk or other property insurance.

Assessing your protection

Just because your contract contains a waiver of subrogation clause doesn't necessarily mean that you're fully protected. The breadth of protection depends on the terms of the parties' insurance policies and the applicable law in the relevant jurisdiction or jurisdictions.

First, for an insured party's waiver of subrogation to be effective, its policy must permit the insured to waive the insurer's subrogation rights. Many standard property insurance policies authorize waiver of subrogation, but some require an endorsement.

Second, the treatment of subrogation waivers varies from court to court. Some courts, albeit a minority, make a distinction between work and nonwork damages. In other words, the waiver extends only to property that's part of a contractor's "work," as defined in the contract. It doesn't prohibit subrogated claims related to nonwork property.

So, in our previous example, the waiver of subrogation would apply only to the subcontractor's electrical work; it wouldn't prevent the insurance company from bringing a claim for damages to other parts of the building. (The "majority rule," however, holds that a subrogation waiver bars claims by the insurer for both work and nonwork property.)

Getting the full picture

Before signing a construction contract that contains a waiver of subrogation, consult your attorney, CPA and insurance rep to get a full picture of its level of protection and potential impact on profitability. ■

Cross-training can help mitigate the labor shortage

It's an unfortunate fact of life that shows no signs of diminishing soon. The construction industry continues to struggle with a shortage of skilled labor. Many contractors find themselves sorely limited in the size and number of projects they can take on because they simply don't have the workforce to deploy.

One way to mitigate the problem is to make better use of the workers you already have on staff. Undertaking a carefully planned and patiently executed cross-training initiative might be a good way to do so.

Identify the invaluable

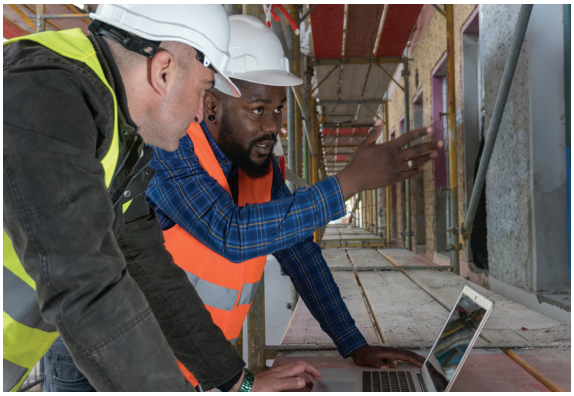
Who are your key employees? An impressive title and a hefty paycheck are two clues; these people generally are invaluable to your organization for strategic vision or the successful completion of jobs. Yet, a top exec or project manager (PM) isn't the only one whose unanticipated absence can substantially impede your operations.

An employee with critical information or experience, if absent, may adversely affect your routine — and profits — right away. For example, what if a top estimator quits for a competitor or the only equipment operator who knows how to run a given asset fails to show up?

In recent years, as jobs and the technology supporting them have become more complex, a gradual movement from "generalist" to "specialist" has taken place. If a specialist leaves your construction company, no one may be able to do his or her work. The remedy? While you don't want to create specialist clones, you can train your flexible generalists to perform specific duties.

Assess your organization

As you might imagine, the time to deal with the loss of a key employee isn't the moment he or she



turns up missing or departs for another employment opportunity. It's when you're at or near full staffing that you should:

- Look at your operations,
- Identify potential staffing or skills vulnerabilities, and
- Develop a cross-training initiative that may close up some of these gaps.

One rule of thumb: The more critical the skill or function, the better off you'll be if more than one person understands it.

Broaden responsibilities

Pay particular attention to the types of projects you typically perform and any new procedures you may have established. Do employees know how to cover for their co-workers — at least generally? If not, start cross-training now.

Then again, backup personnel who never get a chance to practice what you teach them will soon forget what they've learned. So, wherever possible, broaden staff members' job responsibilities to create some healthy overlap.

For example, if your construction company handles its own payroll functions, try to rotate these tasks among two or more employees. That way more than one person will be capable of doing this critical job, which has a low tolerance for error.

In addition to ensuring a smooth workflow in the event of an unexpected absence, cross-training brings the scrutiny of a larger number of workers to each task. These extra eyes can improve efficiency — and discourage fraud.

Include your managers

You hire (or promote) managers to provide leadership, so the sudden loss of an employee who performs key functions is a prime opportunity for managers, whether those in the office or PMs, to demonstrate their "stuff."

Although managers need not know how to perform every function of every employee, they should know at least how to keep operations running without hitches in the short term. Encourage supervisors to informally reverse-train within their departments. It will prepare them to fill in or train others in the event of an employee loss.

Do employees know how to cover for their co-workers — at least generally? If not, start cross-training now.

Beyond that, managers should know where to quickly find temporary help with the necessary tasks if needed. Have a reliable and legally compliant go-to temp labor source for both administrative and project-related tasks.

Boost flexibility

Providing cross-training for executives, PMs, tradespeople and even entry-level laborers can help you develop a more flexible, productive workforce. Doing so can also provide at least a little breathing room while you look for the skilled workers sought after by so many of today's construction companies. ■

6 tips for more effective change orders

In the construction industry, change orders are a fact of life. The trick is making them a profitable one! Managing change orders wisely can make the difference between a successful job and a losing one. Here are six tips to better managing the process:

1. Read the contract. This may sound obvious, but contractors often assume things about approval procedures that aren't reflected in the legal language. For instance, the markup percentage for change orders should be agreed on and documented. Be particularly careful when working on a job with an unusual or unfamiliar contract type.

2. Obtain approval promptly. Generally, it's best to wait until a change order is approved in writing before beginning out-of-scope work. Approved change orders usually allow you to adjust incurred costs, total estimated costs and total contract price. If quick approval isn't feasible, recognize that unpriced or unapproved change orders can negatively affect your financial statements.

3. Include additional time. Additional work almost always requires additional time, and this should be spelled out clearly in the change order. Don't assume the owner knows this or wait until the end of the job to bring it up.

4. Account properly. A complete discussion of change order accounting rules is beyond the scope of this article. But be aware that accounting missteps can have serious consequences.

For example, if you record change order costs in total incurred job costs to date without a corresponding adjustment to the total contract price and total estimated contract costs, sureties and lenders may find that you've excessively underbilled. And if you're overly optimistic about the likelihood that you'll collect change order revenue, it can cause project profitability to fade as it nears completion.

5. Don't work for free. As you strive to provide great service, you may be tempted to perform work outside the contract's scope when an owner decides or is required to change the building plans. But if the scope changes, you should be compensated accordingly. Of course, there are exceptions to every rule, as Tip #6 indicates.

6. Consider no-cost change orders. In select cases, there may be benefits to working for free. For example, doing so can help you avoid conflicts and generate goodwill with an owner you'd like to work with again. You might also mitigate the impact of back charges and provide leverage for quicker release of retainage.

If you decide to provide additional work for free, document these freebies by providing the owner with a "no-cost change order." This way, you'll communicate the added value while tracking the expenses involved. ■

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