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CONSTRUCTION INDUSTRY ADVISOR

New accounting standard

Are there leases hiding in your contracts?

Respond quickly to succession plan troubles

7 tips for avoiding construction disputes

The potential of robotic process automation

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New accounting standard

Are there leases hiding in your contracts?

Late last year, the Financial Accounting Standards Board granted a one-year reprieve from new lease accounting rules to private companies that comply with Generally Accepted Accounting Principles (GAAP). This means that GAAP-compliant construction businesses with a calendar year end now have until 2021 to implement Accounting Standards Codification (ASC) Topic 842, *Leases*. (Contractors with a fiscal year end need to implement the new standard for fiscal years beginning after December 15, 2020.)

Although the extra time is good news, don't delay your efforts to prepare for the new rules and assess their impact. If your construction company leases real estate, equipment or other property, the new standard may have a significant effect on your balance sheet and alter the financial ratios that lenders and sureties use to evaluate your financial performance.

Watch out for embedded leases

Among the biggest challenges under the new standard will be to identify and account for "embedded leases" hidden in other types of agreements — such as service, supply, transportation or information technology (IT) contracts.

ASC 842 generally defines leases to include agreements that convey the right to control the use of an identified asset for a period in exchange for consideration. "Control" means the right to direct the asset's use and to obtain substantially all the economic benefits resulting from that use.

Under this definition, it's possible that contracts not ordinarily viewed as leases may be deemed to contain embedded leases. Suppose, for example, that a construction business contracts with a transportation service provider to deliver heavy equipment or materials to its site. Although this arrangement is essentially a service contract, it may include embedded leases if it requires the provider to use specific trucks, railcars or other vehicles.

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Here's another example: Say your construction company engages a manufacturer to produce certain prefabricated building components. If, under your direction, the manufacturer uses a dedicated facility or production line to fulfill the contract, it may contain an embedded lease.

A brief recap of the new lease accounting rules

Under current rules, leases are accounted for either as "capital" leases, which generally involve a transfer of ownership of the underlying asset, or "operating" leases, which merely transfer the right to use the asset during the lease term. The former are recorded on your firm's balance sheet; the latter are not.

Accounting Standards Codification (ASC) Topic 842, *Leases*, is designed to improve transparency and comparability by requiring most leases to be recorded on the balance sheet, regardless of whether they're capital leases (called "finance" leases under the new rules) or operating leases. There's an exception for "short-term" leases, defined as those with a term of 12 months or less. For each operating lease covered by the new standard, you must record both an asset (reflecting the right to use the leased property during the lease term) and a liability (reflecting your obligation to make lease payments during the term).

Moving operating leases onto the balance sheet doesn't change your construction company's underlying economic circumstances but, by immediately increasing your liabilities, the new rules may make your balance sheet appear weaker and, in some cases, may cause you to violate loan covenants tied to certain debt-related financial ratios. So, you may need to contact your lenders to discuss modifying loan covenants to avoid inadvertent violations.

IT contracts also often hold embedded leases. For instance, a construction company engages an IT vendor to provide a cloud-based project management solution. To satisfy the contractor's processing and security requirements, the parties' agreement requires use of a dedicated, customized server under the contractor's control. This arrangement may constitute an embedded lease of the server.

These are just a few examples of the types of contracts that may contain embedded leases. Keep in mind that not all contracts that involve the use of one or more assets contain such leases. The answer depends on a contract's specific terms. For example, if a service provider retains control over an asset or has the right to freely substitute an alternative asset throughout the agreement's term, the arrangement likely doesn't contain an embedded lease.

Take inventory

To begin preparing for the new lease accounting standard, take inventory of your leases to evaluate the potential impact on your balance sheet. Also, assess your relationships with lenders, sureties and others in light of the new rules.

In addition to reviewing traditional lease agreements, it's critical to examine all contracts — including service, supply, transportation and IT agreements — for potential embedded leases. Once you identify an embedded lease in a contract, you may need to separate the contract into its lease and nonlease components and allocate the consideration between them.

You might also have to modify or supplement your systems, processes and internal controls to ensure that you can track and report your leasing activities under the new rules. Obviously, all of this will likely increase your administrative costs and the amount of time it takes to handle your construction company's leases.

Stay in compliance

ASC 842 doesn't just affect your business; it impacts your project partners and vendors as well. Work closely with your CPA to fully grasp the requirements and undertake the process and documentation changes that will ensure you stay in compliance with GAAP. (For more background, see "A brief recap of the new lease accounting rules" above.) ■

Respond quickly to succession plan troubles

Family-owned construction businesses often face distinctive challenges when it comes to succession planning. Emotions can run high, and the business owner's lifelong working legacy may be at stake. Once you've chosen a successor, and put a basic succession plan in place, it's important to respond quickly if trouble starts brewing.

Form your team

Succession problems can be complex to diagnose and solve. A team approach can help. By involving as many pertinent parties as possible, you can get a more complete perspective on addressing problems and finding solutions.

Keeping key individuals informed and part of the process also helps promote support throughout the rest of the transition. Those who should be involved include your chosen successor, members of your board of directors or advisory board, managers, family and key nonfamily employees, shareholders and investors, and professional advisors such as your attorney and accountant.

Although you may have overlooked some of these important constituents during the planning process, it's never too late to involve them. Express concerns openly while stating your commitment to making the situation right going forward. People typically respond more positively if you're honest and accountable for your own mistakes.

Consider alternatives

One common occurrence for many contractors is that, as time goes on, a chosen successor may not show signs that he or she is truly up to the task of running a construction company. Maybe the successor doesn't have the aptitude for the advanced technical requirements of the job. Or perhaps he or she just isn't a "people person" and struggles with the sales and public relations aspects of the construction business.

In such cases, consider retaining control of the company while your next-in-line acquires more experience working in various areas of your business and developing skills through training and advanced education. Another strategy is to name an interim CEO. You can step back into an advisory role while the interim CEO keeps your business plans moving forward and your successor gets up to speed.

Ask for help

If, after you take the previous steps, your succession plan is still off track, it may be time to bring in outside assistance. Professional advisors, preferably experienced in the construction industry, have the knowledge and skills necessary to shed objective light on the situation. You could be too close to it, so your judgment may be muddied by emotional bias or family conflicts.

Another common problem for construction companies is that there's insufficient cash available for the successor (or other family shareholders) to buy out the business owner. For assistance, call

your financial and legal advisors. They can help you evaluate and effectively structure funding options, such as:

- Selling business assets or stock,
- Gifting stock,
- Obtaining a bank loan,
- Getting seller financing if your successor can't qualify for a loan, or
- Using private investment capital.

A family business management consultant can assist by weighing options from both a family and an employee standpoint and devising strategies for addressing potential conflicts. This may include helping to keep peace by giving ownership interests to family workers and different assets to other beneficiaries, such as property and life insurance proceeds.

Be prepared for anything

The last, but potentially necessary, resort is to revisit your successor choice. After getting input from key individuals in your organization, outside advisors, and even customers and suppliers, you may discover you need to find a new leader-to-be.

No one can afford to continue investing in someone who can't successfully lead the business forward. Your successor may even agree with the decision, choosing to maintain an ownership stake and turn over management responsibility to a more qualified or motivated individual.

Search for a solution

Many family-owned construction companies offer their local communities a unique blend of personality, skills and experience. Passing all this down from one generation to the next is no easy task. As you create and refine your succession plan, be diligent and flexible. The right solution will present itself eventually. ■

7 tips for avoiding construction disputes

A single construction dispute can turn a profitable job into a loss; multiple ones can put a contractor out of business. Here are seven strategies for avoiding them:

1. Draft contracts carefully. Ambiguous contract language is probably the most common cause of legal wrangles for contractors. Pay close attention to provisions that affect your right to compensation and/or extensions of time in the event of owner-caused delays or changes. These include change order provisions, no damages for delay clauses, differing site condition provisions and substantial completion requirements.

2. Monitor jobs closely. No matter how well drafted your contracts, disputes can still arise if your project managers and crews don't follow contractually mandated procedures. For example, be sure they understand the change order approval process and follow it to the letter. This means complying with all notice and approval requirements and documenting additional costs thoroughly.

3. Have an accurate schedule. It's difficult, if not impossible, to assess the impact of delay claims or change orders without an accurate baseline schedule accepted by all parties at the start of the project. A solid schedule also serves as a tool for identifying delays early and taking steps to prevent or minimize them before they lead to potential disputes. If you regularly find yourself falling behind on job progress, look into refined scheduling methods and technology to shore up this problem.

4. Stay up to speed with applicable laws and regulations. Keep up with laws and regulations that affect your types of projects. If you work on public jobs, for instance, federal or state rules may require certain mandatory contract clauses — and courts may interpret the contract as containing these clauses even if they're omitted. Failure to comply with these rules is an invitation to disputes or litigation.

5. Train project managers. By the time a construction company owner learns of a dispute, it's often too late to prevent dire consequences. Project managers are typically in the best position to spot potential difficulties as they arise. Train yours to identify troublesome issues and act quickly to resolve them. Doing so can often mitigate problems before they turn into full-fledged conflicts.

6. Consider alternative project delivery methods. New approaches, such as integrated project delivery (IPD), can help reduce disputes. In IPD, contractors, owners and architects (and even major subcontractors and suppliers) enter into a mutual contract. Doing so helps avoid disputes because the parties collaborate from the beginning — agreeing on goals; target costs; and allocation of responsibilities, risks and compensation. Often, they waive liability claims against one another (except for willful misconduct) and make decisions by unanimous consent, subject to arbitration or another alternative dispute resolution mechanism.

7. Take advantage of technology. Evolving technologies that enhance collaboration and information sharing can help reduce disputes. Take building information modeling (BIM). This technology creates 3-D or even 4-D models that enable the parties to view the completed project from different angles to better understand the spatial relationships between building components. It also helps job contributors see how changes in design or materials affect the project. Notably, by helping the parties identify and resolve design conflicts before construction begins, BIM can be an effective dispute-avoidance tool. ■

The potential of robotic process automation

Robotic process automation (RPA) isn't new, but improvements in the technology and shrinking costs have made it more accessible than ever. By taking over repetitive, mundane, time-consuming tasks, RPA can reduce costs, increase efficiency and productivity, minimize errors, and free up employees to focus on higher value activities. The technology holds promise for construction companies, which often face razor thin margins and a shortage of skilled labor.

What is it?

The term may conjure images of androids roaming the job site, but RPA simply refers to software tools that automate repetitive, rule-based human tasks. Examples include:

Creating invoices. Properly designed RPA solutions can compile necessary billing data (from multiple systems, if necessary) and create accurate invoices in a matter of minutes.

Generating estimates. RPA systems can quickly generate preliminary numbers based on data collected from customers or prospective customers.

Managing documents. Manual systems are prone to human error, and documents are easily lost. RPA can automatically route scanned documents to the appropriate recipients and file them in a centralized, accessible repository.

Processing vendor invoices. RPA systems can collect data from invoices, enter it into a company's accounting system, and generate an email confirming receipt and requesting additional information if needed.

Monitoring performance. RPA can be used to generate and analyze work-in-progress reports to ensure that jobs are progressing profitably. It's also able to provide an early warning of cost overruns and other potential problems.

Responding to customer or prospect inquiries. RPA systems can respond to basic requests received via a business's general email address or website. In the case of more complex requests, the system is capable of forwarding the inquiry to the appropriate person.

Performing HR tasks. RPA can be used to automate a variety of tasks involved in recruiting, onboarding, payroll, and other labor- and document-intensive HR processes.

Why consider it?

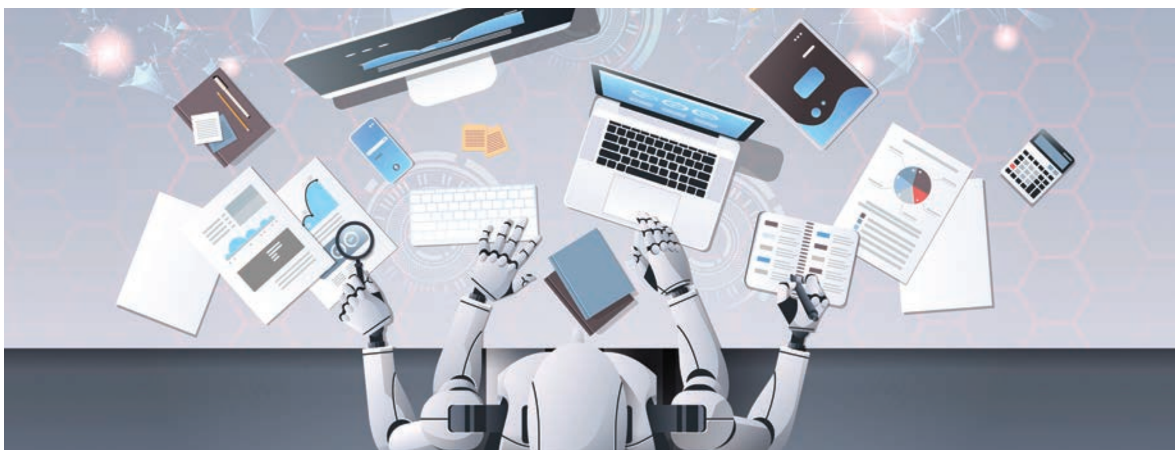
As mentioned, RPA offers a variety of potential benefits for contractors. It reduces labor costs and virtually eliminates human error in many forms of documentation. Plus, because "bots" can perform tasks much faster than people, and can work 24 hours a day without breaks, RPA reduces the time it takes to complete applicable tasks.

RPA can automatically route scanned documents to the appropriate recipients and file them in a centralized repository.

Although there's a chance that RPA will eliminate certain jobs, overall it may help retain employees by taking over dull, repetitive tasks; reducing employee burnout; and freeing staff members to focus on more skilled, creative and fulfilling activities.

Okay, how much?

As is the case with any technology, there are considerable costs associated with buying, implementing and maintaining the appropriate type(s) of RPA software. If interested, approach the idea cautiously and explore the details carefully. ■



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