Summer 2022

CONSTRUCTION INDUSTRY ADVISOR

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New lease accounting standard is here (for real this time)

Does your construction business follow Generally Accepted Accounting Principles (GAAP)? And does it lease equipment, real estate or other assets? If you answered "yes" to both questions, your company should be implementing the new GAAP lease accounting standard now.

The new standard, which will be reflected in your 2022 year-end financial statements, could have a significant impact on the ratios that lenders and sureties use to evaluate your company's financial health. Therefore, you should discuss the changes with your leadership team and, if appropriate, negotiate adjustments to loan covenants or other contractual requirements.

Implementation delays

It's easy to understand why the new lease accounting rules fell off the radar for many construction businesses. The Financial Accounting Standards Board (FASB) issued its new lease standard more than six years ago, followed by a series of delays in its implementation dates.

Most public companies adopted the standard in 2019, but the FASB gave private businesses an extra year to implement it, followed by a one-year delay in late 2019. After the COVID-19 pandemic hit, the FASB delayed the implementation date once again, to fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

Given the pandemic's continuing economic impact, many had hoped that the FASB would postpone implementation even further. However, in November 2021, the board voted unanimously against another delay. This means calendar-year companies must apply the new lease standard beginning with their year-end 2022 financial statements and 2023 interim financial statements.

A brief refresher

Under the previous rules, leases were classified as either "capital" or "operating." Capital leases, which generally involve a transfer of ownership of the underlying asset to the lessee, were recorded on a company's balance sheet. In contrast, operating leases, which transfer only the right to use the asset during the lease term, weren't recorded on the balance sheet, though they might be disclosed in the footnotes.

The new lease standard retains the distinction between operating leases and capital leases — the latter of which are now referred to as "finance" leases. Although the definitions of capital and

Beware of embedded leases

To comply with the new lease accounting standard (see main article), simply reporting traditional lease agreements isn't enough. You'll also need to identify and account for "embedded leases" hidden in other types of agreements, such as service, supply, transportation or information technology (IT) agreements.

Under the standard, a "lease" includes any agreement that conveys "the right to control [an identified asset] for a period of time in exchange for consideration." You possess control if you have both the right to direct an asset's use and the right to obtain substantially all economic benefits of that use.

For example, suppose your construction business contracts with a supplier to deliver materials to jobsites. If your agreement provides that one truck from the supplier's fleet will be dedicated solely to making deliveries to your company, the provision could be considered an embedded lease of the truck for financial reporting purposes.

Another example: Your company contracts with an IT vendor to provide a cloud-based construction management system. If the agreement requires the vendor to use a dedicated server under your control to ensure data security, the arrangement might constitute an embedded lease of the server.

These are just two of many possible examples of embedded leases. Whether a contractual arrangement constitutes an embedded lease depends on the agreement's specific terms.

finance leases are slightly different, in substance, they both refer to leases that closely resemble the financed purchase of an asset.

To improve transparency and financial statement comparability, however, the new standard requires both operating and finance leases to be recorded on the balance sheet. (There's an exception for short-term leases; those with terms of 12 months or less.)

For an operating lease, the lessee records a "right-of-use" asset and a corresponding liability for lease payments over the expected term. Generally, both the asset and liability are based on the present value of minimum payments expected to be made under the lease, with certain adjustments.

Impact of the new standard

If your construction company has multiple operating leases, you might need to modify your financial reporting systems and procedures to ensure that you're collecting the information you'll need to comply with the new standard. In addition, you'll have to review other types of contracts not usually viewed as leases to identify "embedded leases" that you also must record on your balance sheet. (See "Beware of embedded leases" above.)

It'll be critical to evaluate the impact of the new standard on your financial statements. Moving operating leases to the balance sheet will increase your liabilities, which can make your financial position appear weaker or cause you to violate loan covenants tied to certain ratios.

Bear in mind that changing the way leases are reported doesn't affect the underlying financial state of your construction business. But it's important to discuss the impact with lenders and sureties to make sure there are no surprises. In some cases, you might need to modify your loan covenants or other agreements accordingly.

Time is of the essence

If the new lease standard applies to your construction business, and you've yet to begin transitioning to it, you can't afford to wait any longer. Don't underestimate the amount of administrative and accounting work involved in ensuring compliance. Your CPA can be an invaluable resource in understanding what you need to do and getting it done. ■

Prepare for project delays with savvy financial strategies

Although construction activity tends to ramp up nationwide over the summer, that doesn't mean everything goes as planned. A project that looks sunny on paper can turn into a hot mess if it experiences serious delays. Make sure you're prepared.

The usual suspects

As you've likely experienced, various unforeseen events can bring a job to a grinding halt. One of the usual suspects is inclement weather. Mother Nature plays no favorites and cares not for a construction schedule. Document the number of days and the severity of adverse weather events. Meanwhile, keep your crew ready to regroup and redeploy as soon as conditions clear. Doing so will demonstrate that your company did nothing to exacerbate the delay.

Another usual suspect is a project owner running into financial issues. Owners or developers sometimes run out of money mid-project and must renegotiate financing or seek new funding sources. Meanwhile, no one gets paid. You can improve your chances of avoiding such situations by fully researching a job before submitting a bid.

Sometimes discord disrupts a project. You've probably worked on a job or two that wasn't all sunshine and rainbows. Perhaps the owner disputed choices of materials or in what order certain tasks should be completed. Some owners communicate better than others; some are simply impatient. It's for these predicaments that superior communication skills and a thorough knowledge of dispute-resolution methods are critical.

Risk recognition

Whatever the cause of the delay, your construction company needs to be able to recognize and quantify its financial risk. Informally, one can define financial risk as the likelihood of negative possibilities — from being unable to meet your short-term obligations (payroll, accounts payable) to, at its most extreme, failure of the business.

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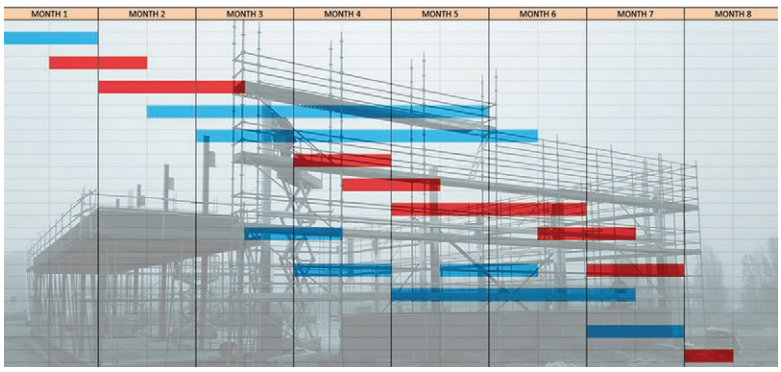
Financial risk tends to proportionately increase as a construction-company owner panics or succumbs to reactionary measures. For example, if an owner's payment is delayed, some contractors might decide to drag out performance because they're not getting paid.

A smarter move is to recognize the short-term risk of liquidated damages as well as the longer-term risk of nonrenewal of awarded contracts.



These dangers can lead to ongoing and potentially devastating cash-flow constrictions.

Protective measures

No one can predict the future. If a construction company is always relying on its next payment to stay in business, one delayed project can spell disaster.

Many contractors turn to lines of credit to insure themselves against job delays and slow payments. But a line of credit is like a mortgage that never gets paid off, because interest is charged on the open balance. Even if you keep up with the payments, you're still accruing interest. And interest charges will explode exponentially if you must repeatedly use the line to bail yourself out whenever an owner or general contractor doesn't pay up.

For this reason, among others, you'll be better served by prudent, proper financial management. This begins with what can be a big challenge for many contractors: creating and maintaining a cash reserve. A general rule of thumb says every small to midsize business should keep on hand enough cash to cover anywhere from three to six months of operating expenses.

If you're struggling to maintain your cash flow as it is, this may sound like a tall order. Yet a cash reserve is really the only foolproof defense against project and payment delays. When you have the money to cover payroll, supplies and the like, you also have peace of mind.

Your CPA can help you determine how to best go about establishing and maintaining a cash reserve. One way is to set up an interest-bearing account for this purpose and determine a reasonable percentage of cash to set aside from each job.

Not if, when

Project delays are practically inevitable. Every construction company should establish sound risk management policies to mitigate the worst financial effects. Review and refine yours for the busy months ahead. ■

8 tips for managing your supply chain

The COVID-19 pandemic and other world events have triggered or worsened supply chain risks and shortcomings affecting many industries — including construction. Materials or equipment shortages or delays can be devastating to a project, so it's critical for contractors to actively manage their supply chains. Here are eight strategies to consider:

1. Develop and maintain strong supplier relationships. This is especially critical during challenging times. Reach out regularly and keep the lines of communication open so you'll learn about potentially troublesome developments and have time to plan for any shortages. Establish a strong payment history — including early payments, if possible — to nurture goodwill.

2. Be transparent with customers. Inform project owners when materials get scarce, or you can't get your hands on necessary equipment. Ideally, you should address these issues in your bids to ensure customers understand upfront the potential impact of shortages on job costs or progress.

3. Put an expiration date on your bids. Keeping bids open for a relatively short period — for example, 30 days — can help protect you against

unexpected shortages and price increases. You can always extend the time, provided you confirm the availability of materials and equipment.

4. Negotiate contractual protections. If possible, protect yourself by making start or completion dates contingent on delivery of scarce materials.

5. Order in advance. If you anticipate that materials or equipment will be hard to come by, consider ordering them in bulk ahead of time. Granted, doing so will affect your cash flow and could result in added costs (off-site storage, for instance).

However, acting ahead might help you avoid sudden shortages while locking in current prices. Determine whether you can negotiate contracts that provide for early release of funds to make advance purchases when necessary.

Ideally, you want a real-time, big-picture view of the entire logistics process.

6. Diversify your supply chain. Investors reduce risk by diversifying their portfolios. Similarly, construction companies can reduce their risks by diversifying their supply chains — that is, developing a mix of suppliers of different sizes and in different geographical regions.

Doing so can mitigate the risk that comes from doing business with only one supplier. If a natural disaster, political instability or economic factors disrupt a supplier's ability to meet your needs, others can step in and minimize the negative impact.

7. Have a Plan B (and C). Develop contingency plans in the event of materials or equipment shortages. For example, explore a relationship with another construction company in which you might be able to buy some of their stockpiled supplies or borrow equipment. Another idea is to explore design changes that allow you to use different materials that are more readily available.

8. Use supply chain management software. Construction supply chains can be complex. Ideally, you want a real-time, big-picture view of the entire logistics process. This can be difficult to do with manual processes or spreadsheets.

Given the heightened risks in the current environment, consider using supply chain management software to automate and enhance the process. These solutions can help you evaluate suppliers, spot potential vulnerabilities, track shipments and even model "what if" scenarios to develop contingency plans. Your CPA can help you evaluate the costs vs. benefits of the software purchase. ■

How can contractors use wearable technology?

Construction companies are increasingly using wearable technology to improve the building process. As you're probably aware, the term refers to a wide variety of hands-free electronic devices that can be worn directly on the body or embedded in hard hats, boots, vests or other gear.

Typically, wearables are powered by microprocessors and internet-connected, so they can send and receive data wirelessly and in real time. The uses in a construction context are practically limitless, but here are a few examples.

Productivity and training

Augmented reality (AR) headsets or glasses overlay digital imagery onto the user's physical surroundings, providing visual cues and real-time information that can streamline and improve a variety of construction activities.

For example, a worker wearing an AR headset or glasses can superimpose three-dimensional models over what has already been built to ensure that work is being completed as planned and to correct mistakes before they cause major problems. In turn, job progress speeds up, making work crews and equipment more efficient and less costly.

AR technology can also help train workers more quickly than traditional methods by creating a fully immersive environment. AR glasses can identify components of sophisticated equipment or demonstrate complex construction tasks in a realistic setting.

Safety and security

Among the most important uses of wearables is to improve safety. Smart watches, smart helmets and other wearables can monitor workers' vital signs and detect signs of heatstroke, fatigue or other life-threatening health conditions. Smart boots equipped with motion or pressure sensors are able to detect falls and alert emergency personnel on the jobsite who might be well out of visual range of a mishap.

In addition, wearable technology can help prevent accidents involving heavy equipment or vehicles. Radio frequency identification (RFID) tags embedded in hard hats or safety vests track workers' locations, while sensors mounted on equipment or vehicles can detect tagged workers and sound an alarm if they're too close.

This technology can also be used to improve security on the jobsite by limiting access to workers with RFID-equipped badges.

A powerful tool

The examples described above represent a tiny fraction of the many ways wearables might be of use to your construction business. They're a potentially powerful tool for enhancing productivity, reducing errors, improving safety and streamlining communications.

Of course, they're also not free. Like any technological investment, putting dollars into a wearables purchase should be preceded by careful due diligence into the needs of your company, the tech savvy of your employees, and the short- and long-term costs. ■