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CONSTRUCTION INDUSTRY ADVISOR

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Get ready for new lease accounting rules

Earlier this year, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, the FASB's long-awaited overhaul of its lease accounting rules. The ASU makes extensive changes to the treatment of lease transactions, particularly for lessees.

What do the new rules require?

The most significant change involves operating leases. Under current Generally Accepted Accounting Principles (GAAP), leases are classified either as "capital" or "operating" leases. Although the rules for classifying leases are complex, in general a capital lease transfers ownership of leased assets to the lessee, while an operating lease simply transfers the right to use the leased assets during the lease term. To keep leases "off the books," most companies prefer to structure leases as operating leases, which need not be reported on their balance sheets (though they require certain footnote disclosures).

To make it easier for financial statement users to compare companies that own their productive assets with those that lease them, the ASU requires lessees to report *all* leases on their balance sheets, regardless of how they're classified. There's an exception, however, for short-term leases — those with terms of 12 months or less. For leases subject to the new rules, you'll recognize a "right-to-use" asset and a corresponding lease liability (both based on the present value of minimum payments under the lease) on your balance sheet.

The new standard retains the distinction between operating leases and capital leases (referred to as "finance" leases) for purposes of reporting lease expenses on your income statement. For operating leases, you'll generally recognize rental expense on a straight-line basis. For finance leases, however, you'll amortize the right-to-use asset separately from interest on the lease liability. This will result in "front-loaded" expense recognition, similar to a loan.

How much time do you have?

The new rules will apply to fiscal years starting after December 15, 2019 (a year earlier for public companies). That may seem like a long way off, but consider making preparations soon. Evaluate the new leasing standard's potential impact on your financial statements and talk to your sureties and lenders about how it might affect your bonding capacity or compliance with loan covenants.

Also, keep in mind that the ASU calls for a "modified retrospective" transition. This means you'll have to apply the new rules as of the beginning

of the earliest comparative period presented on your adoption-year financial statements. In other words, if you include comparative financial information in your financial statements, you'll need to have appropriate reporting systems, processes and internal controls in place well before the effective date to ensure that you collect the information you need to implement the new rules.

To ease the burden of this transition, the ASU allows you to elect certain "practical expedients." Generally, these elections permit you to continue using most aspects of current GAAP to account for existing leases (unless they're modified), although you'll still have to report an asset and a liability on your balance sheet.

How will this affect surety bonds and loans?

If you lease real estate, equipment and other assets, implementing the new standard will significantly increase the assets and liabilities recorded on your balance sheet. This, in turn, may affect your bonding and lending relationships.

Although your net worth won't change, additional liabilities may make your balance sheet appear weaker, which may increase your borrowing costs or reduce your bonding capacity.

Another potential concern is that the new standard will negatively impact loan covenants that place limits on the total amount of debt you may incur or require you to maintain certain debt-to-equity levels. To avoid causing companies to violate loan covenants, the ASU specifies that lease liabilities should be treated as "other liability," not "debt." But the actual impact on your company will depend on your loan agreements' language and the specific financial ratios used.

What's next?

To prepare for the new leasing standard, review your current and contemplated leasing arrangements, evaluate the standard's potential impact on your financial statements and ensure your financial reporting systems are equipped to collect the information you'll need to comply. In addition, talk to your lenders and sureties to discuss the impact of the new standard, if any, on your ability to obtain financing and bonding. ■

Watch out for combined contracts

It's not unusual for contracts to contain both lease and nonlease components. For example, an equipment lease might also include an agreement to provide maintenance services. Under the Financial Accounting Standards Board's Accounting Standards Update (ASU) No. 2016-02, it will become more important to separate a contract's lease and nonlease components and to account for nonlease components separately under other standards.

To avoid the burden of allocating the contract price between lease and nonlease components, you may elect to account for them together as a single lease component. But in light of the on-balance-sheet treatment of leases, there may be a significant advantage to putting processes into place to identify and value the lease and nonlease components of your contracts.

Show me the money

Ways to keep your profits on track

While the U.S. economy continues to improve, contractors must carefully watch their bottom lines. This means keeping track of how increases — or decreases — in profitability can affect your construction company. The following are ways for your company to maintain its profitability.

Review your overhead

"Overhead" or "indirect costs" — expenses that aren't directly related to your projects — are easy to ignore. Examples of indirect costs include:

- Project management,
- Purchasing,
- Contract administration,
- Safety oversight, and
- Salaries.

Other indirect costs include small tool, fuel and supply, and freight charges. Taxes, title transfers, permits, bonds and job insurance, and shop and marketing costs are all typically considered indirect costs, too.

If your construction company fails to properly allocate indirect job costs to projects, you're missing out on opportunities to recoup expenses and submit accurate bids. So how can you reduce these costs? Analyze indirect costs and their relationship to your operating results. This can help you determine which costs are fixed, which are variable and which are a little of both.

Just as you're sometimes flexible with parties that owe you money, creditors may be willing to work with you.

Changing fixed costs can be tough. Try negotiating with your lenders, landlords, utility providers and others you regularly do business with. Look to trim variable costs by cutting out (or down on) unnecessary expenses.

Once you've done this, construct a budget for indirect costs to plan for the coming year. Regularly compare your budgeted amounts for indirect costs with your actual spending. If you're going over budget, look for ways to cut back.

Manage receivables and payables

It's easy to take for granted the management of construction receivables and payables. You do the construction work, generate an invoice and send it out. Bills come in and you pay them as appropriate.

One receivables strategy to consider is front-loading contract billings. Generally, this involves shifting some profits into

earlier phases rather than applying a flat rate to all phases, as is normally done. But don't be too aggressive; overbilling can alienate your owner or general contractor, which can cause problems down the line. But, when done properly, this strategy can help you collect some of your profits before the retainage is paid on completion.

What if you're experiencing a cash flow shortage? If you've always paid vendors within 30 days, consider extending your payment cycles. Ask for a break from your creditors to help you handle the cash crunch and deal with cost overruns. Just as you're sometimes flexible with parties that owe you money, creditors may be willing to work with you.

Control change orders

Make sure to address change orders properly. Doing so can help protect and even bolster your bottom line. This means that you need to know your contract so you can quickly identify a change and how it differs from the original agreement.

Take the time to review your change order system. Having a written, signed and authorized change order that will get you paid requires careful recordkeeping. Maintain daily reports, project correspondence, meeting minutes, schedules, cost records, photos and other documentation to help indicate an operational change.

Finally, provide written notice and an explanation of how your revised work will affect the schedule and delivery date. Include a date on the notice to prove you gave owners plenty of time to adjust to the associated costs. Following these steps will help increase the likelihood you'll get paid for the extra work, without fighting a defense from the owners based on lack of notice.

The bottom line

As with any business, having a healthy bottom line is crucial for contractors. You may already be implementing some of the concepts here, and it may be time to start others. To keep your profitability on track, talk to your financial advisor. ■

Pay attention to "no damages for delay" clause

Construction contracts often contain "no damages for delay" clauses, which prevent a contractor or subcontractor from recovering delay damages from a property owner or general contractor. Whether, and to what extent, parties to a contract can enforce these clauses depends on the contract's language and state law.

Limited remedies for delays

By denying a contractor the right to recover monetary damages for delays, a no damages for delay clause essentially limits the contractor's remedy to an extension of time to complete the work. These clauses are sometimes drafted to include no extension even when the delay is beyond the contractor's control.

Thus, when a contractor's work is delayed through no fault of its own (and no exceptions apply), it can't obtain compensation for the resulting costs. These costs can include increased bond or insurance premiums, extra supervision costs, additional equipment or utility costs, and higher home office overhead. Despite these consequences, no damages for delay clauses are valid and enforceable in most states, provided their language is clear and unambiguous.

Exceptions may apply

The existence of a no damages for delay clause doesn't mean that a contractor can't recover delay damages under any circumstances. First, it depends on the contract's language. Some contracts permit a contractor to recover damages for delays that are within the control of the owner or general contractor.

In addition, many states provide court-created exceptions. Laws vary from state to state, but many states have exceptions for delays not contemplated by the parties, and delays so unreasonable that they constitute abandonment of the contract. Other common exceptions include delays caused by the other party's:

- Bad faith or willful, malicious or grossly negligent conduct,
- Breach of a fundamental contractual obligation, or
- Active interference.

Often, in litigation, a critical issue is the meaning of "active interference."

Laws vary from state to state, but many states have exceptions for delays not contemplated by the parties.

Case in point

In *C&H Electric, Inc. v. Town of Bethel*, the town hired C&H to do electrical work in connection with a school renovation and expansion. The town indicated that certain asbestos abatement work would be completed before construction began, but it moved forward with the construction, even though only 70% of the asbestos abatement work

was completed. This interfered with C&H's work, and C&H sued to recover delay damages.

The contract contained a no damages for delay clause that expressly excluded delays caused by the town's active interference. The Connecticut Supreme Court agreed with C&H that establishing active interference doesn't require a showing of bad faith or gross negligence. Rather, C&H merely needed to show that the town had committed some "affirmative, willful act that unreasonably interfered with [C&H's] work." In this case, the Court rejected C&H's claim because it failed to present evidence that town representatives "actually knew that the unfinished abatement work would interfere with the plaintiff's work."

Be prepared

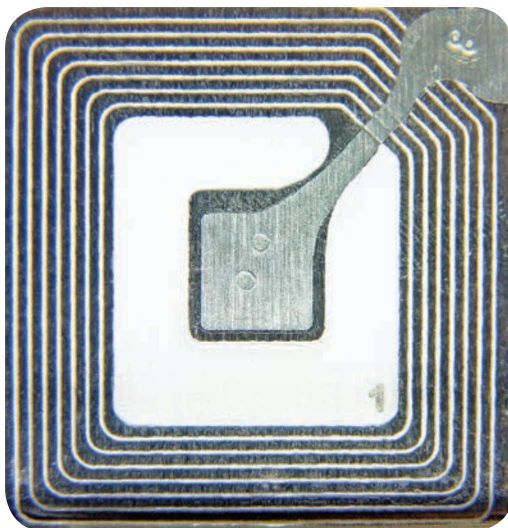
To increase your chances of recovering delay damages, review no damages for delay clauses carefully, understand any relevant state law exceptions and attempt to negotiate more favorable terms. By keeping thorough, accurate records of all project delays and documenting all communications with the owner or general contractor, you'll be prepared in the event of litigation. ■

Four ways contractors are using RFID technology

Radio frequency identification (RFID) technology has proven to be a powerful tool that can help contractors manage equipment and materials, reduce theft, enhance efficiency, and improve safety. Electromagnetic fields identify and track RFID tags — tiny computer chips with attached antennas — affixed to various objects. Contractors can read these tags remotely on a laptop or mobile device. Here are four ways this technology is being used in construction:

1. Tracking tools and equipment. You can place RFID tags on virtually any tool or piece of equipment, regardless of size. This allows a contractor to track their movement in real time, which helps deter theft, allows the contractor to manage these assets more efficiently, and helps pinpoint their location in a laydown yard or other storage facility. Tags may even provide usage information and maintenance schedules.

RFID tags are difficult to remove. For larger pieces of equipment, you can hide or embed them where would-be thieves can't find them. And for smaller assets, such as hand tools, you can "print" the RFID tag on the item using "magic ink," a chemically enhanced ink that makes it possible to print circuits that perform like computer chips.



2. Managing inventory. Contractors can use RFID technology to manage materials and supplies on a job site, across multiple job sites, or even in transit. This ensures access to the materials when and where they're needed. You can also replenish supplies before they're depleted. RFID tags can also provide detailed information to ensure that contractors use the right materials. They can even let workers know how old an item is or when it was last inspected or certified.

3. Managing personnel. RFID tags aren't just for inanimate objects. Increasingly, contractors are using them to track people, too. By placing tags in workers' hardhats or ID badges, contractors can determine where workers are and what they're doing. Contractors can use RFID tags for time tracking, eliminating timecards and reducing time-related disputes, by having workers pass through portals equipped with an RFID reader. RFID also helps reduce unauthorized access to a job site or to specific areas within a job site.

4. Improving safety. There are many ways to use RFID technology to improve safety. For example, contractors can install RFID readers near potential hazards and design them to activate an alarm when a worker approaches. They can also alert management if a worker enters an area without the proper authorization or certification. And in the event of an accident or emergency, workers can be located quickly.

These are just a few examples of the many ways contractors are using RFID tags. The potential benefits of RFID technology are limited only by the creativity of those who use it. ■

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Helping Contractors Build Success

Succeeding in the construction industry takes smart bidding, quality work, savvy management — and the assistance of advisors who know the business and can help move your company ahead.

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We are ready to help you with a broad range of tax, accounting and business management issues, including:

- Accounting systems and controls
- Project bidding and estimating
- Change orders and closeouts
- Cost segregation studies
- Tax planning and filing
- Estate and succession planning
- Bonding and financing
- Job costing and project management

We would welcome any questions you may have on the topics discussed in this newsletter or on other issues affecting your business. Please contact our office at 217.351.2000 and let us know how we can be of assistance.