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Let's talk about leases

New accounting standard to usher in significant changes

If your construction company leases assets, and it follows U.S. Generally Accepted Accounting Principles (GAAP), an important development occurred earlier this year. The Financial Accounting Standards Board (FASB) issued its long-awaited update revising the appropriate treatment of leases on financial statements: Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. Affected construction companies should start assessing its impact now.

Understanding the changes

Under existing GAAP rules, how you disclose the existence of a lease on your financial statements depends on whether it's a capital lease or operating lease. Capital leases are listed as assets and liabilities on your balance sheet. So, for instance, if you've leased a piece of construction equipment for nearly all of its useful life, that's where it would go.

Operating leases, on the other hand, currently are disclosed only as a rent expense and disclosure item. In other words, they typically don't appear on a company's balance sheet. An example of one of these would be a lease of office space for a period of 10 years.

The FASB's new guidance, ASU 2016-02, changes all this. It requires lessees to recognize assets and liabilities for *all* leases — both capital and operating — with terms of more than 12 months. You must also state the right to use a leased asset on your balance sheet as an asset and the obligation to pay rent (discounted to present value) as a liability.

In addition, ASU 2016-02 requires lessees to make additional disclosures on their financial statements. These disclosures include information regarding the amount, timing and uncertainty of cash flows related to your leases. For example, you'll need to provide details on variable lease payments and any options you might have to renew and terminate a lease.

Discerning the classifications

The two primary classifications, capital and operating, will continue to play an important role in the accounting of leases. In fact, they'll continue to impact your recognition, measurement and presentation of expenses and cash flows arising from a lease.

In the case of capital leases, lessees must amortize right-to-use assets separately from interest on the lease liability on their statements of comprehensive income. On your statement of cash flows, you'll have to classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities.

Otherwise, you probably won't see a big difference in ordinary capital lease accounting — although, under the new standard, you should expect to see capital leases referred to as "finance leases" much more consistently.

Many of the changes wrought by ASU 2016-02 have to do with operating leases. For instance, lessees will need to recognize a single total lease cost, calculated so that the lease's cost is allocated over the term — typically, on a straight-line basis. And you'll classify cash payments within operating activities on your statement of cash flows.

Anticipating the impact

As a construction company owner specifically, you'll likely notice the effect of ASU 2016-02 in a variety of ways. Assuming you do lease multiple assets, your balance sheet will likely get a bit longer as you add these items (as appropriate) to it. In turn, by doing so, your reported assets and liabilities will also increase. And this is where you might see the most significant impact.

A rise in reported assets and liabilities could affect the ratios that lenders and other users of your financial statements use to assess your construction company's performance. For example, you may need to review and even renegotiate debt covenants you have in place with your lender, because your balance sheet may look less optimal. Your surety might also view your bonding capacity differently in light of the changes.

On an administrative level, ASU 2016-02 may initially increase your accounting staff's workload. You and your staff will need to fully understand the guidance and revise your financial statements accordingly. You might also need to implement new processes and internal controls.

Gearing up

The good news is that you have plenty of time to gear up for the changes. Nonpublic, GAAP-compliant businesses don't need to comply with ASU 2016-02 until annual and fiscal years beginning after December 15, 2019, and for interim periods beginning a year later. (You may adopt provisions earlier.) Work with your CPA to paint a clear picture of how the guidance will affect your construction company's financial statements.

FASB addresses the complexity of combined contracts

In many cases, leases for vehicles or pieces of equipment have two components: 1) the lease itself, and 2) a service contract for maintenance of the asset. This added complexity is discussed in Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, issued by the Financial Accounting Standards Board (FASB).

Costs associated with the nonlease component aren't considered a part of the lease payment. Therefore, they should generally be excluded from the measurement of lease assets or liabilities. So you'll have to distinguish the lease component from the service contract, which is considered a "nonlease" component. ASU 2016-02 includes detailed instructions for making this distinction.

If your construction company happens to act as a lessor, rather than a lessee, contract consideration is performed according to the allocation guidance in the FASB's revenue recognition standard. Overall, ASU 2016-02 doesn't bring great changes to lessor accounting. But, should you lease out assets, be sure to discuss the guidance's impact with your CPA anyway.

Job rescue: Best practices when playing the hero

A funny thing has happened on the way to today's improved economic environment for construction. Many developers and contractors have leapt unprepared into big projects and found themselves unable to complete the work. These misfortunes create opportunities for other construction companies to step in and "play hero." But before you don the red cape, be sure to consider some best practices.

Know what you're getting into

First determine how the project became troubled. Was the original contractor unqualified? Did he or she run into financial difficulty? Were the owners or subcontractors part of the problem? To get a feel for the situation:

- Visit the site,
- Review meeting minutes and other key project documents, and
- Speak to the owner, subcontractors, architects and engineers.

Also, if possible, meet with the original contractor's representatives to get their insights into what went wrong. This information will help you decide whether to take the job and, if you do, to avoid similar problems. For example, make sure you know the owner's and surety's teams that you'll be working with to complete the job.

If possible, document the original contractor's work. Create a record of the job's status — using photographs or video — before you begin your work. Doing so will help protect you against any claims for defective work attributable to your predecessor.

One particular word of caution: Given the inherent perils of taking over a troubled project, don't increase your vulnerability by stepping out of your comfort zone. Be sure the job is within your construction company's core competencies.

Consider the contract

Although the owner may expect you to "step into the shoes" of the original construction company, your contract to complete the project may require some adjustments. Review its language to, again, identify any changes in the scope of work or other disputed issues that must be addressed in the new agreement.

Given the circumstances, it's likely that the project has been delayed. If the original contract's completion date is no longer realistic, determine a reasonable completion date and negotiate appropriate

changes. Also, determine the extent to which completion of the job depends on work performed or materials and equipment supplied by the owner, subcontractors, suppliers or other third parties. Confirm the status of these parties and build appropriate lead times into your schedule.

Additionally, make sure you understand the change order procedures and that you obtain proper authorizations from the owner, the surety or both, if necessary, before you proceed. This is particularly important if the original contractor was bonded and the surety has taken over the project.

Check on funding, too. Be sure that the lender is willing to sign off on a new contract. Because the cost to complete the project may be more than originally anticipated, confirm that there's sufficient funding to cover monthly draws.

Build your rebid carefully

Partially completed projects often necessitate a rebid of the work based on current site conditions, a new scope of work in light of what's been done as well as what's left to be done, and the current status of materials and equipment. So you may need to obtain bids from existing or new subcontractors, and possibly replace any subcontractors that contributed to the job's troubles.

Keep in mind that, because the project is troubled, it's likely to require a higher degree of management oversight and documentation than an ordinary job. Be sure to provide ample workers and assign a project manager who's adept at handling difficult jobs and reacting quickly to problems. It's also a good idea to incorporate contingency funds to cover uncertainties, such as additional work to correct latent defects left by your predecessor.

Take a well-calculated risk

As the saying goes, "Nothing ventured, nothing gained." Stepping into a troubled project is a risk. But, if you make it a well-calculated risk, the revenue gained can make your bottom line a little more … heroic.

It pays to be picky when choosing a business partner

There comes a point in the existence of many construction companies when the owner may want to bring in a partner. This is usually a good sign — the company is probably growing and there's just too much work or opportunity for one person to handle.

If you find yourself in such a situation, be as patient and choosy as possible when picking your partner. And make sure you know, well in advance, how this change will affect your construction company's tax liability.

Complementary roles

Essentially, there are two major facets to choosing a business partner: strategic and financial. Let's start with the strategic.

Obviously, adding a partner isn't something one should do on a whim or just because you enjoy working with a fellow contractor. Doing so has

got to be part of a well-conceived, carefully planned strategic expansion of the business. Ask yourself questions such as:

- Where do I want to take my company that I can't get to on my own?
- Can a partner help me get there — or just slow me down?
- Do I need a partner, or is an employee or consultant the better choice?

It's particularly important that any prospective partner *complement* you. Remember, the word cuts both ways. Of course your partner can't be someone too different from you — he or she must share your values and overall approach to doing business. But a partner must be significantly different from you as well. Ideally, he or she needs to excel in one or more areas in which you tend to struggle.

A typical problem in partnerships occurs after two people unite because of a common skill or passion in a certain area. Unfortunately, they end up competing over the work involving that skill or passion. So if you're a "hands-on, work-at-the-jobsite" kind of owner, a partner who excels in, say, technology or sales might be a good fit.

Tax impact

Then there's the financial side. You'll naturally have to establish salary levels, benefits, and a sound and efficient approach to sharing financial information. But it's tax liability that can often sneak up on new partnerships with unpleasant surprises.

> *Ideally, a partner needs to excel in one or more areas in which you tend to struggle.*

For tax purposes, partnerships are "pass through" entities — meaning that income passes through to the owners' respective personal tax returns. Partnership income may also be subject to employment taxes. And this particular business entity choice doesn't protect personal assets from creditors — if an owner is a general partner. Limited partners are liable only up to the amount of their investments.

For these reasons — and simply the fact that construction projects expose contractors to so much risk and liability — forming a limited liability company (LLC) may be a good idea. LLCs are, by default, taxed as partnerships. So they're also pass-through entities. But LLCs shield owners' personal assets from business-related debts and court judgments. In fact, for larger or more risky projects, some construction companies set up an LLC specifically for the job in question.

Carefully made move

Aside from selling your construction company, bringing in a co-owner is among the most impactful changes you could make. That doesn't necessarily mean it's a bad move; it's just got to be a carefully made one.

THE CONTRACTOR'S CORNER

What could go wrong with our new accounting software?

After years of suffering with outdated accounting software, I've decided to buy a new system for my construction company. The vendor has agreed to help me with installation and training. But what really worries me is actually using the software. What are the typical problems you've seen contractors encounter when implementing a new accounting system?

Great question. Many construction company owners buy accounting software and, even if the installation goes well, quickly grow frustrated when they don't get the return on investment they'd expected. From an accounting perspective, two of the primary implementation risks that contractors face are bad data and missed opportunities.

Cleaning up

You've probably heard that old tech adage, "garbage in, garbage out." The "garbage" referred to is bad data. If inaccurate or garbled information goes into your system, the reports coming out of it will be flawed. And this is a particular danger when transitioning from an older software platform to a newer one.

For example, you may be working off of inaccurate inventory counts or struggling with duplicate vendor entries. On a more serious level, your database may store information that reflects improperly closed quarters, unbalanced accounts because of data entry errors or outstanding retainage on old jobs.

A methodical, analytical implementation should uncover some or, one hopes, all of such problems. You can then clean up the bad data and adjust entries to tighten the accuracy of your accounting records and, thereby, improve your financial reporting.

Seizing opportunities

Another major risk to construction accounting software implementation is imprecise or incomplete job-costing data. Contractors face a distinctive challenge in integrating not only general business accounting data, but also the details of multiple, ongoing projects. A typical approach is to move job-costing info from the old system to the new one as quickly as possible, using whatever on-the-fly method seems most expedient.

Naturally, doing so can lead to data transfer errors. But, again, there's also a risk of missed opportunity here. When upgrading to a new system, you'll have the chance to improve your job costing. You may be able to, for instance, add new phases or cost code groups that allow you to manage project expenses much more efficiently and closely.

Beyond job costing, other opportunities for improvement include optimizing your chart of accounts and improving your internal controls. Again, to obtain these benefits, you'll need to take a slow, patient approach to the software implementation.

Getting a leg up

Just thinking about what could go wrong will give you a leg up on avoiding the biggest disasters. To further increase your chances for success, involve your CPA in the implementation.

LAPORTE
CPAs & BUSINESS ADVISORS

111 Veterans Memorial Blvd, Suite 600 | Metairie, LA 70005-3057
504.835.5522 | FAX 504.835.5535

The **LaPorte Construction Industry Group** has worked with construction clients for over half a century. We understand the special audit, tax, and consulting needs of construction-related businesses.

Our professionals – including five certified construction industry financial professionals (CCIFPs) – work hard to raise the bar on serving their clients and on educating themselves, resulting in tangible benefits for our clients. Also, our professionals attend annual construction conferences, giving us a broader industry perspective on our clients' operations and making us more able to offer technical proficiency and bring valuable ideas to the table.

Commitment to the Construction Industry

Our professionals actively participate in the following trade organizations and associations, often in leadership roles:

- American Subcontractors Association
- Associated Builders & Contractors
- Associated General Contractors
- Commercial Real Estate Women
- Construction Financial Management Association
- Construction Industry CPAs/Consultants Association
- National Association of Women in Construction
- Surety associations in Louisiana and Texas

Construction Client Base

- General contractors
- Heavy and highway contractors
- Marine and shipbuilding contractors
- Oilfield services contractors
- Pipeline contractors
- Real estate developers
- Residential and nonresidential builders
- Specialty trade contractors

Services to the Construction Industry

Compliance

- Attest and assurance
- Tax return preparation

Tax Consulting

- Business valuations
- Cost segregation studies
- Equipment buy vs. lease decision analyses
- Executive compensation reviews and evaluations
- Family business succession planning
- Guidance on payroll tax and independent contractor issues
- Guidance on sales and use tax issues for contractors
- Identification of available federal and state credits
- Multi-state income and franchise tax planning
- Planning for application of advantageous long-term contract tax accounting methods

Other Consulting

- Benchmarking analyses
- Internal control studies and evaluations
- IT risk and controls assessments
- Payroll and benefits services
- Performance/operational reviews
- Software training support
- State contractors licensing applications
- Technical accounting support, including assistance with implementing new accounting pronouncements

The LaPorte Construction Industry Group has more than five decades of experience serving the industry. For more information on our practice, contact Director Douglas Hidalgo, CPA, CCIFP, at dhidalgo@laporte.com.