On-Site

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NO MORE DRAMA

Build stability and value into your succession plan

You need look no further than the hit TV show "Succession" to see how lack of a clear succession plan can tear a family — and business — asunder. Although the power struggles and drama are certainly heightened on the show, the dangers of failing to think ahead about leadership change are anything but fictional for construction businesses.

Don't drag your feet

In a 2021 Construction Financial Management Association (CFMA) survey of construction executives, 50% of respondents reported they didn't have an "ownership transfer plan." That's up from 39% in 2017. The figures aren't surprising — humans are naturally reluctant to think about their later years or death. And construction company owners are usually busy with the day-to-day details of keeping their businesses profitable.

But the failure to think through succession can hurt a company's value. This is particularly true when the owner is a larger-than-life character who's popular with employees, customers, vendors, lenders and other stakeholders. Uncertainty about the future can lead to heated intrafamily disputes — or even ruptures — that can affect the many relationships that the owner has cultivated over the years.

Get the ball rolling

The first step is to define your succession-planning goals. Common examples include:

- Securing future financial stability for the owner, family members and the business,
- Keeping the company in the family,
- Treating children fairly whether they work for the business or not, and
- Giving valued employees an opportunity to step up and share in the company's profits.

Owners who wish to be succeeded by a child or other family member should talk to the younger generation to gauge their interest and identify their skill sets. If anyone is pressured to take over, the construction company will likely suffer. Everyone must be on the same page about future roles, responsibilities and the corresponding financial rewards.

Weigh transfer options

Two-thirds of the respondents in the CFMA survey intend to sell their businesses to family members, employees or a combination of both. Family ownership transfers are often done through a gift or sale. The right choice depends on a variety of factors, including whether the owner needs retirement funds.

Gifting can make it easier to shift responsibilities for debts or other liabilities, while also reducing the owner's taxable estate. Then again, owners who go the sale route have multiple options for structuring the deal. An installment plan, for example, could work as an annuity in retirement.

Note that a construction company's purchase price probably will be less for family members than if the business were sold to a third-party buyer. But internal transfers can avoid some of the risks

3 VALUATION METHODS FOR BUY-SELL AGREEMENTS

The valuation method used when transferring ownership interests of a construction business through a buy-sell agreement can make a big difference in the ultimate purchase price. Common options include:

1. Fixed price. An agreement can specify a fixed price reached through negotiation among the shareholders, ideally with the assistance of a business valuation professional. Although a fixed-price provision has the benefit of simplicity, it must be updated regularly to reflect changing circumstances.

2. Prescribed formula. Some buy-sell agreements adopt a simple formula to establish the buyout amount. For example, an agreement may specify that "shares will be purchased at three times earnings before interest and taxes for the previous 12 months." But formulas typically apply to historical financial results, rather than projected results, and thus might not reflect a business's current value.

3. Independent appraisal. A buy-sell agreement can mandate a formal business valuation by a valuation professional to establish the company's value at the time of the buyout. Valuations generally consider current circumstances and produce more accurate results.

that come with outside owners, such as culture change. There's also a better chance that the outgoing owner can retain some control through, for example, voting shares.

Stock redemptions are another alternative. Under these arrangements, the company buys some or all of the owner's shares, increasing the ownership of the remaining shareholders.

For instance, if the owner has an 80% interest and his two children each have a 10% share, the owner can sell his interest, resulting in each child having a 50% interest. Redemptions must be carefully structured so the balance sheet isn't weakened, and the company doesn't fall out of compliance with any bonding or lending covenants.

A stock redemption might be required under a buy-sell agreement. Such agreements often calculate the stock's price according to an agreed-upon valuation method. (See "3 valuation methods for buy-sell agreements" above.)

Additional transfer options include recapitalization and employee stock ownership plans. Every option has pros and cons, including tax implications. Construction business owners should consider everything before choosing any approach.

Train your successor

Few designated successors are ready to drop into a company's top position on a dime. Proper preparation is vital — and it's not an overnight process.

A comprehensive training program will help reassure lenders and sureties that leadership will remain competent, knowledgeable and trustworthy. Construction business owners should evaluate intended successors for gaps in skills or other qualifications, so they can address them in advance.

The gaps might call for continuing education courses, on-the-job training, long-term mentoring and, finally, hands-on leadership experience. Responsibilities such as directing staff and interacting with lenders, customers and surety agents can then be gradually handed off.

Act now

It can take years to properly develop and implement a succession plan. Don't wait until you're on the cusp of retirement to get started. Your professional advisors, including your CPA and attorney, can help guide you through this typically complicated and emotional journey. ■

PROPER ACCOUNTING FOR CHANGE ORDERS MAKES ALL THE DIFFERENCE

If there's any aspect of the construction business that gives you mixed feelings, it's probably the humble — or in some cases not-so-humble — change order. On the one hand, the circumstances that give rise to change orders tend to be disruptive and often cause confusion or even conflict between contractors and project owners.

On the other hand, a change order can generate more revenue from a job and, if expenses are kept in line, lead to a greater profit when all is said and done. One often-overlooked aspect of change-order management is proper accounting. When you know the numbers, you'll have a much clearer picture of the situation.

Are we doing this right?

Customers can sometimes change their minds after signing a contract, but before work is completed. To keep projects on schedule, it's not unusual for contractors to begin out-of-scope work before a change order is approved. But failure to properly track and account for the costs and revenue associated with this work can have a negative impact on your financial statements.

Suppose, for example, that you record costs attributable to a change order in total incurred job costs to date, without making a corresponding adjustment to the total contract price and total estimated contract costs. To a lender or surety, this might indicate excessive underbillings.

In other cases, profit fade can occur if you're overly optimistic about your chances of receiving change-order revenue. If you increase the total contract price based on out-of-scope work but are unable to secure change-order approval, your profit could fade as the job progresses. This can also shake the confidence of financial statement users.

How to categorize?

Without proper tracking procedures, you might inadvertently forget to charge customers for change orders in accordance with the contract terms. Change orders generally fall into three categories.

First, there are *approved* change orders. For this category, it's appropriate to adjust incurred costs, total estimated costs and the total contract price. Depending on the contract's change-order provisions, this may increase your construction business's estimated gross profits.

Second, you might wind up with an *unpriced* change order. If the parties agree on the scope of work but leave pricing negotiations for later, the accounting treatment depends on the probability that you'll recover your costs. If doing so is improbable, change-order costs are treated as costs of contract performance in the period during which they're incurred. Therefore, the contract price remains unadjusted, and your estimated gross profit will decrease.

If you probably will recover the costs through a contract price adjustment, you can generally either:

- Defer the costs until you and the owner have agreed on the change in contract price, or
- Treat them as costs of contract performance in the period incurred and increase the contract price to the extent of the costs incurred (resulting in no change in estimated gross profit).

To determine whether recovery is probable, consider your background knowledge of the owner, as well as your experience negotiating similar change orders. If it's probable that the contract price will be increased by an amount that exceeds the costs incurred (increasing estimated gross profit), you might recognize increased revenue — provided realization of that revenue is "assured beyond a reasonable doubt."

Finally, there are *unapproved* change orders. These should be treated as claims. It's appropriate to recognize additional contract revenue only if, under guidance provided in the accounting rules, it's probable that a claim will generate such revenue and the amount can be reliably estimated.

Who can help?

For the purposes of this article, we've assumed you're using the percentage-of-completion accounting method. Whatever you approach you use, tracking and reporting change orders can be complex. Your CPA can help assess your change-order process and help you improve the accuracy and usefulness of your financial statements. ■

WHAT IS BONDING CAPACITY, REALLY?

Many construction companies rely on their ability to procure surety bonds to win projects. Owners of those jobs — government agencies in particular — often require bonding to guarantee that work will be completed one way or another.

As you're likely aware, contractors are urged to manage their financials carefully to preserve and even increase their bonding capacities. But what is bonding capacity, really?

The three Cs

Simply defined, bonding capacity is the maximum amount of credit a surety will provide to a contractor. The term happens to be one of the "three Cs" of bonding, which include:

1. Character. This refers to whether a construction company can be trusted to honor its contract obligations. Sureties look at your business reputation, including your successes with previous projects and track record of paying suppliers. Honesty about financial information and completeness of the bonding application is a good indicator of character, as well as your communication methods with the surety.

> Capacity is one of the "three Cs" of bonding.

2. Capital. This indicates financial strength. Many sureties look at adjusted working capital — the difference between current assets (such as cash and accounts receivable) and current liabilities (such as accounts payable and short-term debt). A surety will scrutinize your financial statements to set your bonding limit, which generally ranges from 10 to 20 times your adjusted working capital.

3. Capacity. As mentioned, this is the maximum amount of bonding you can qualify for, based on your total ability to fulfill a contract. Sureties look at your equipment, labor and other resources, as well as the type and size of contracts completed.

For example, if you want to secure a $10-million contract, but the largest contract you've completed to date was $5 million, the surety will likely be concerned about your capacity to deliver a project of that size. With materials costs rising, an increasingly common problem for many contractors is getting bonded for projects of the same scope but with now-higher pricing.

Ideas for boosting capacity

Here are a few ways you might be able to boost bonding capacity:

Take out a shareholder loan. Also called a capital injection, these loans are among the quickest, easiest ways to "inject" cash into the business and increase working capital. Shareholder loans are typically subordinated to the surety to be treated as equity and working capital. Thus, you'll need permission from the surety to repay it.

Step up collections. Sureties usually remove receivables that are more than 90 days old from working capital unless you can show they've been collected or will be soon. Focus on collecting receivables in or near this 90-days-old bracket.

Sureties also tend to remove amounts a construction business has loaned to related parties (such as an affiliated company or subsidiary) from working capital. Ensure these amounts are paid back or reduced before year end.

Defer insurance renewals. Work with your insurance rep to push back any renewal payment dates that fall before year end. Doing so will reduce prepaid expenses for the year, which will increase working capital.

Strengthen your position

Now's a good time to build up your bonding capacity as public infrastructure jobs come online, and the economy is less affected by the pandemic. Work with your CPA to better understand and strengthen your construction company's working capital position. ■

6 WAYS TO FORTIFY YOUR CYBERSECURITY DEFENSES

Small to midsize businesses might assume hackers won't bother with them. But construction companies of any size are indeed a prime target for cybercriminals.

In fact, construction was the top industry hit by ransomware attacks between 2020 and 2021, according to a report by NordLocker. The encryption software firm analyzed 1,200 companies across 35 industries that have fallen victim to ransomware.

More recently, U.S. government officials and cybersecurity experts have warned about a potential increase in cyberattacks originating from Russia following the country's invasion of Ukraine. Smaller companies with limited IT resources are especially vulnerable. Here are six ways to fortify your cybersecurity defenses:

1. Conduct regular cyber risk assessments. Evaluate your systems to ascertain the types of data your staff generates and processes and where it's stored. From there, you can implement the latest protective steps. Because technology changes rapidly — as does the sophistication of cyberattacks — follow these procedures at least annually.

> The latest cybersecurity standard is to require multiple log-in credentials.

2. Educate employees. Ensure every staff member knows how to properly use technology, handle confidential information and report cyberthreats. Provide targeted training on dangers such as phishing, malware (emails or other messages with suspicious links or attachments) and ransomware. Cybersecurity training should also occur as part of new-hire onboarding, whenever a new device is issued and at least annually as a refresher.

3. Use multifactor authentication. Every device, system and app should be password-protected to prevent unauthorized access. However, the latest standard is to require *multiple* credentials, such as a password and a numerical code, to add another layer of security. Many insurers are enforcing this standard by requiring it for cybersecurity insurance. If your construction company's employees use personal devices at work, instruct them to use multifactor authentication as well.

4. Keep software updated. As updates and patches are released, be sure they're immediately downloaded onto your construction business's systems and devices. And, again, if your workers use personal phones or other devices on the job, train and remind them to check for and download updates as soon as they become available.

5. Erase hard drives before disposal. Laptops, mobile devices, tablets, and even some printers and copy machines hold sensitive data and must be fully wiped before disposal. The same goes for leased equipment before returning it.

6. Look into cybersecurity insurance. This coverage is designed to mitigate losses from a variety of incidents, including data breaches, business interruption and network damage. At minimum, a policy should cover liability for data breaches involving sensitive customer information, such as credit card numbers and driver's license numbers. Like any type of insurance, cybersecurity coverage should be purchased only after careful due diligence and within a sensible budget. ■

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Accounting for Leases in 2022

In early 2016, the Financial Accounting Standards Board (FASB) released new guidance on how businesses should account for leases. That new standard went into effect this year. Has your company made the transition?

What Is the New Lease Accounting Standard?

Under the new accounting standard, **Accounting Standards Update (ASU) 2016-02, Leases (Topic 842)**, nearly all long-term leased assets should be recorded on the balance sheet. In general, the only leases that can stay off the balance sheet are non-recurring leases with terms less than 12 months.

The new guidance affects the following two lease categories:

- **Finance leases** give you the right to use an asset for most (or all) of its useful life. Finance leases were known as "capital leases" under prior GAAP guidance.
- **Operating leases** give you the right to use an asset for a period that is less than the asset's useful life. Assets that businesses want to upgrade frequently (like company cars) are typically leased under operating lease agreements.

Under prior GAAP guidance, only capital leases (now known as finance leases) were shown on the balance sheet. Under the new accounting standard, the FASB wants to see both finance and operating leases on the balance sheet. Both should be recorded as (1) a "right of use" asset and (2) an accompanying liability for the present value of the remaining lease payments.

When Does the New Standard Go into Effect?

Non-public entities should apply the new guidance on annual reports for periods that begin after December 15, 2021, and on interim reports for periods that begin after December 15, 2022.

What Should You Be Doing?

As you begin implementing the new standard, here are just a few things you should be doing:

Talk to your banker.

When operating leases make their way to your balance sheet, your financial ratios will change, and you may find yourself in violation of your debt covenants. Talk to your bankers to see if you need to renegotiate your contracts. Bonding agents may also need to adjust their analysis when determining your bonding capacity.

Get buy-in.

Remind all members of your team, not just your accountants, that ASU 2016-02 is going to change day-to-day operations. Your project management team and purchasing department need to know what's required so the revamped reports can come together smoothly.

Consider new software.

Accounting for your leases will require more work than it did in the past. You may find it useful to have software that tracks and collects details about each of your leases.

Prepare your disclosures.

It's not just the face of your financials that will change; ASU 2016-02 also impacts footnote disclosures. Prep those disclosures now, well before the year-end rush.

Understand the fine print.

Understanding the basics isn't enough. ASU 2016-02 is hundreds of pages of new guidance. Reach out to others in the construction industry and professionals you trust to ensure you haven't overlooked anything.

The bottom line is that if you have leases, the new lease accounting standard is going to affect you. Contact LaPorte Construction Industry Group Co-leader Tracy Tufts, CPA, CCIFP, (ttufts@laporte.com) if you need help implementing this new standard.