Construction accounting update

**New lease rules may add ink to your balance sheet**

**Making the most of preconstruction**

**Will your construction company last forever?**

**Plus!**

Construction Success Story

**General contractor takes a look at telematics**

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Construction accounting update

# NEW LEASE RULES MAY ADD INK TO YOUR BALANCE SHEET

Does your company lease any of its vehicles or equipment? If so, and you follow U.S. Generally Accepted Accounting Principles (GAAP), some important news transpired earlier this year.

Namely, the Financial Accounting Standards Board (FASB) issued its long-awaited update revising the appropriate treatment of leases on your financial statements: Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. Although compliance isn't required immediately, the guidance will likely add some ink to your balance sheet in the future.

## New rules

Under existing rules, leased business assets are accounted for in two different ways, depending on the classification of the lease in question. Companies typically recognize *capital* leases as assets and liabilities on their balance sheets. So, for example, if the lease term of the piece of construction equipment is for most of its expected useful life, you'd classify this as a capital lease.

Meanwhile, *operating* leases have been handled differently. For instance, if you signed an office lease for 10 years, you wouldn't recognize this on your balance sheet. Rather, it would appear on your financial statements as a rent expense and disclosure item.

Under ASU 2016-02, GAAP-compliant businesses must now disclose on their balance sheets assets and liabilities for *all* leases of more than 12 months. You can no longer separate the two classifications.

As a lessee, your company will have to report a right-to-use asset and a corresponding liability for the obligation to pay rent. But you'll have to

discount the asset to its present value using either a rate implicit in the lease or the lessee's incremental borrowing rate.

## Classifications endure

The aforementioned classifications remain relevant, however. They'll determine the recognition, measurement and presentation of expenses and cash flows arising from a lease.

Specifically, for capital leases, lessees must amortize right-to-use assets separately from interest on the lease liability on the statement of comprehensive income. So, on your statement of cash flows, you'll classify repayments of the principal portion of the lease liability within financing activities.

Meanwhile, you'll denote payments of interest on the lease liability and variable lease payments within operating activities.

When it comes to operating leases, lessees need to recognize a single total lease cost, calculated so that the cost is allocated over the term on a generally straight-line basis. So, on your statement of cash flows, you'll reclassify cash payments within operating activities.

ASU 2016-02 will add other disclosures to help users of your construction company's financial statements as well. For example, as a lessee, you'll need to disclose qualitative and quantitative requirements — such as details of variable lease payments and options to renew and terminate leases.

## Distinctive components

In some instances, you might sign a lease for a vehicle or piece of construction equipment that includes both a leasing component and a service contract component for maintenance of the asset. The new rules will continue to mandate that businesses distinguish leasing components from nonleasing components, and ASU 2016-02 provides guidance for doing so.

The distinction between leasing and nonleasing components generally applies only to lessees. If your construction company acts as a lessor, contract consideration is done according to the allocation guidance in the FASB's revenue recognition standard. (For more details on being a lessor, see "What if *I'm* the lessor?" at right.)

## Ultimate impact

So what will be the ultimate impact of ASU 2016-02? Assuming your construction business leases a number of assets, you'll likely be adding more of these items to your balance sheet — increasing your reported assets and liabilities.

A change like this on your financial statements could affect the ratios that lenders and other financial statement users apply to your numbers. Existing debt covenants could be impacted, and you may face higher borrowing costs if your balance sheet looks less appealing with your operating leases included. Sureties may also re-evaluate

### WHAT IF *I'M* THE LESSOR?

Some contractors have found that leasing out equipment and, in some cases, property is a useful way to create an additional revenue stream.

If your company acts as a lessor, you won't likely encounter a major difference in your accounting practices as you comply with Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. (See main article.)

Companies that own leased assets (lessors) will see little change to their accounting from current GAAP. The new standard does, however, include some "targeted improvements" intended to align lessor accounting with both the lessee accounting model and the updated revenue recognition guidance published in 2014 (ASU No. 2014-09, *Revenue from Contracts with Customers*).

You might notice some minor changes, however. The new standard seeks to better align lessor accounting with the lessee accounting model, as well as with recently updated revenue recognition guidance. So, for example, lessors may be required to recognize some lease payments received as liabilities in cases where the collectibility of the lease payments is uncertain. That way, financial statement users will know more about the lessor's leasing activities and exposure to credit and asset risk.

your bonding capacity based on the changes to your financial statements.

Initially, you could also see a rise in accounting expenses. You'll likely need to invest in continuing education for your managers and financial staff. And construction companies should establish additional processes and internal controls to ensure compliance.

### Changes ahead

Nonpublic businesses that follow GAAP don't need to comply until annual and fiscal years beginning after December 15, 2019, and for interim periods beginning a year later. You may, however, adopt ASU 2016-02's provisions earlier. Your CPA can help you incorporate these changes into your construction company's accounting practices. ■

# MAKING THE MOST OF PRECONSTRUCTION

A construction project begins long before the first work crews arrive on the job site. Months, sometimes even years, can pass between the job's conception and the groundbreaking — though much of that time is spent before construction contracts are even awarded.

Once your company has contracted to work on a project, however, it's important to take an active part in preconstruction. Committing to this process will not only help the project to run more smoothly, but also increase the chances that you'll be paid promptly and fairly for your work.

### Common issues

Preconstruction isn't a single thing but rather a range of issues that vary with the nature, scope and complexity of the project in question. For every job, though, the goal should be for all parties involved to be clear on the stated building plans and procedures.

The American Institute of Architects has issued a best practices document called "A Sample Preconstruction Conference Agenda" that outlines common preconstruction issues. Here are some of the most pressing:

**Who's doing what.** Preconstruction should establish the chain of command regarding who's leading the project. It should also delineate who's in charge of submittals (such as shop drawings, engineering data, permits, licenses, tests and inspections) and scheduling (including progress reports and updates, times for submittals, and approvals). In addition, there should be a set schedule for project meetings with clear agendas and attendance requirements.

**Dollars and cents.** Everyone involved needs to be familiar with the contract — particularly its provisions for change orders and dispute resolution. Make

sure you know how it addresses progress payments, including procedures for setting aside retainage, paying for materials and submitting payroll records (if required).

The goal of preconstruction planning is to get everyone on the same page before work begins.

**What goes where.** Much uncertainty can be avoided when preconstruction addresses the logistical structure of the job site. Who will handle the procedures and timetables for ordering electric, gas, water, phone and any other utility services? Which areas will be designated for parking and the storage of materials and equipment? How will you establish site access and rights of way — including cautions about adjacent property, protection of trees and similar issues? Job-site security arrangements should also be discussed.

## Group communication

If these issues aren't raised, or you're unclear about them in any way, it's better to ask questions before you're faced with a problem in the field. Be prepared to provide information as well. If you foresee a problem with scheduling or sequencing your work with that of other trades, bring it up during preconstruction.

By the same token, if you have ideas on streamlining work flow, offer them up and listen to what other project team members have to say. Remember that the goal of preconstruction planning is to get everyone on the same page, but you also may be able to avoid many problems by hashing them out in a group setting before work begins.

## The connected team

An informed, communicative and connected project team boosts the odds that the job in question will run smoothly and efficiently. In turn, this sets the stage for you to be able to execute your best work and keep costs down. Be sure you're making the most of preconstruction. ■

# WILL YOUR CONSTRUCTION COMPANY LAST FOREVER?

As the saying goes, nothing lasts forever. And that probably goes for your construction company. Then again, with the right succession plan in place, you can do your part to ensure it continues down a path of success for at least another generation. From there, it will be your successor's job to propel the business further into perpetuity.

So when should you begin planning your succession? Well, it's never too early to start thinking about stepping down — even if you have no intention of doing so. Here are some key points to consider.

## Drawing up your plans

If you want to be sure your business will continue successfully after you leave, you'll need to draft a succession plan as meticulously as you carry out your building plans. Succession planning isn't easy for a number of reasons.

Unlike estate planning, which is essentially determining the distribution of assets through wills and other tools, succession planning involves people — people in the family, people in the company and, potentially, people outside of either.

You must ask yourself who is best suited to run the business when you depart, and what ownership transfer plan will treat you and all your heirs fairly. This includes knowing when you want to retire and how much income you'll need to do it.

## Preparing your successor

Another critical component of a successful business transition is preparing the next generation to take over. If younger family members are interested in construction, let them work for you in real jobs with real expectations.

Teach them to build projects the way you want them built, and teach them to run your business the way you want it run. And, if they genuinely can't cut it, give them a way out. Sometimes the best way to ensure a construction company's longevity is to let someone outside the family run the company while your heirs stay involved in some other capacity.

> A grantor retained annuity trust will provide you with income for a term of years and then distribute the remaining assets to your beneficiaries.

You can further reduce the chance of friction if you include your family in the succession planning process. Help them understand your values and goals for the business and listen to their suggestions.

## Anticipating taxes

So how do you actually go about "changing the guard" at your company? The simplest way is to sell it, if family members can afford it and want to buy it. You can also transfer ownership by gifting it over time, but there are potential gift tax liabilities associated with this approach — and it won't generate an income stream to carry you through retirement.

A trust may be a better alternative for transferring ownership without creating harsh tax obligations. One option is a grantor retained annuity trust (GRAT), which will provide you with income for a term of years and then distribute the remaining assets to your beneficiaries.

The transfer of assets into the GRAT is a taxable gift, but the annuity you receive reduces the value of the gift. However, a drawback is that, if you die before the end of the annuity period, the trust assets will be included in your estate, the tax advantages will be negated and your beneficiaries will receive nothing.

Whatever means you choose, put your succession plan in writing. Along with selecting a vehicle (or vehicles) to transfer your assets, state whether and how you'll stay involved with the company after you leave. If you try to stay too involved, you may inadvertently inhibit your successors from succeeding. Then again, many former business owners stay on as consultants and are quite helpful.

## Thinking ahead

Construction company owners are usually proficient in both the boardroom and on the job site. As such, you no doubt have a lot of knowledge to pass on to your successor. So be sure to put that person in the best position by taking a patient, thoughtful approach to your succession plan. Your CPA can provide invaluable assistance regarding the income and estate tax impact of your approach. ■

# GENERAL CONTRACTOR TAKES A LOOK AT TELEMATICS

For the first time in years, a general contractor recently visited a construction equipment show. Exhibitors were promoting the benefits of new vehicles and equipment equipped with "telematics." The word, they explained, refers to the transmission of information from machine parts to a central database.

Fleet and equipment owners, the exhibitors trumpeted, can use this data to save money on maintenance, repair and fuel costs. The contractor had to admit his company's profitability was suffering because of project delays caused by mechanical breakdowns and high fuel costs. Still, skeptical of the exhibitors' claims, the contractor asked his CPA about whether telematics might be worth his time and money.

## Basic info

His CPA confirmed that, in a telematics system, sensors attached to key vehicle or equipment parts collect information about the asset's usage and maintenance, and send it to a modem that's also attached to the machine. The modem then transmits it to a database via a cellular or satellite network. The owner can then access the database to generate detailed reports about the equipment.

Basic telematics systems gather information about the location, running time and fuel usage of a compatible vehicle or piece of equipment. With location monitoring, the CPA explained, you can be alerted by phone or email whenever an asset moves outside a prescribed area. These alerts can prevent unauthorized equipment use or theft. Location data also can help service technicians find equipment needing field repairs.

Running time monitoring indicates when an engine is turned on and off. Besides alerting you to unauthorized use, the CPA pointed out, this data pinpoints the actual machine hours needed to complete a project and, thus, can help you craft better bids.

## Advanced functions

More advanced telematics systems, the CPA continued, provide even more data points. For example, "fuel burn" info allows you to develop an oil-change regimen based on more than just operating hours. This can reduce repair costs and boost fuel efficiency.

Some systems build in "fault codes" that raise immediate red flags regarding certain problems. So you can pull a vehicle or piece of equipment out of service before a minor problem becomes a major breakdown.

## Careful investment

Like any technology initiative, the CPA warned, investing in a telematics system should be approached carefully. The contractor could hurt his profitability further by overinvesting in a system that he and his staff weren't prepared to fully use.

In this case, the contractor decided to retrofit some of his newer machines with telematics. As he and his managers become comfortable with this influx of information, they'll consider shopping for new telematics-equipped vehicles and equipment. ■

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To find out what we can do for you, or for more information about the ideas presented in this newsletter, please contact Sean Auger or Steve Pullara at (608) 836-7500 or mail@sgcpa.com. We look forward to talking with you.