On-Site

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THE CONTRACTOR'S CORNER

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HERTZBACH

certified public accountants · consultants

www.hertzbach.com

Baltimore
800 Red Brook Boulevard
Suite 300
Owings Mills, Maryland 21117
410.363.3200

Greater Washington, D.C.
1803 Research Boulevard
Suite 215
Rockville, Maryland 20850
301.315.2150

Northern Virginia
1530 Wilson Boulevard
Suite 700
Arlington, Virginia 22209
703.351.6600

Construction accounting update

New revenue recognition rules to "go live" soon

A new website or updated software "goes live" when it's launched for widespread use. This, too, will soon be the case with an important accounting change for construction businesses that follow Generally Accepted Accounting Principles (GAAP).

For privately held companies, Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, is due to go live with annual reporting periods beginning after December 15, 2018. The new rules will most affect contractors with substantially valuable contracts carried out over considerable lengths of time, transitioning these big-money deals away from a strict percentage-of-completion method to a revised revenue recognition model.

Background

As its name indicates, ASU 2014-09 sprung to life in 2014, when the Financial Accounting Standards Board (FASB) in May originally published the update. Although it's been subject to a number of comment periods and updates since, the objective remains to converge revenue recognition rules under GAAP with accounting rules published by the International Accounting Standards Board (IASB).

Indeed, the new rules are the result of over a decade of work with the IASB to establish one clear reporting method for businesses across the globe. In the process, roughly 180 parts of business- and transaction-specific guidelines under U.S. GAAP were eliminated as the two accounting organizations took a more principles-based approach to revenue recognition.

The result: Under ASU 2014-09, companies must follow a five-step procedure for recognizing revenue:

1. Identify a contract with a customer.
2. Separate the contract's commitments.
3. Determine the transaction price.
4. Allocate a price to each promise.
5. Recognize revenue when or as the company transfers the promised good or service to the customer, depending on the type of contract.

The updated rules may cause some businesses to recognize revenue much differently from what they're accustomed to under current GAAP practices. So it's critical to be prepared for the change and to know just how it will affect your construction company.

New construction

You'll note the second of the five steps listed above is "separate the contract's commitments." Doing so will be key for contractors. More specifically, you'll have to divide your contracts into "performance obligations," which the FASB defines as "promised goods or services that are distinct and should be accounted for separately." For a good or service to be separately recognizable as revenue, the customer must be able to:

- Benefit from that good or service as a standalone item, or
- Use that delivered good or service with only the customer's existing resources (and not be required to receive future goods or services in order to use that good or service).

ASU 2014-09 is likely to have the biggest impact on new construction. Currently, you probably report a variety of common line items separately as recognizable revenue because you sell these goods and services separately. Examples include site clearance, foundation work, construction of a structure, piping and wiring, and installing equipment and finishing.

But, for new construction, contractors must provide a significant level of service to integrate these items (and others) into an overall project for a customer's use. So, in the case of, say, electrical wiring and foundation work, you'll no longer recognize these items separately under ASU 2014-09. Rather, they'll be considered components of revenue that you'll report later.

To be clear, you may be able to *bill* for them separately, but you won't be allowed to *account* for them separately as revenue under the new rules when these line items are billed or paid.

An important concept in following the new rules will be the "bundling" of goods or services. In an update to ASU 2014-09, the FASB directs businesses to aggregate building components until a distinctly deliverable and usable bundle of goods or services is identifiable. This could result in a contractor accounting for all of the goods or services under a new-construction contract as just one performance obligation. If this happens to your company, you may initially report much less income under the new rules than you have in previous years.

What about taxes?

It's always important to remember that recognizing revenue for tax purposes is distinct from doing so for accounting purposes. So, while Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, will bring substantial changes to your accounting ledger, it won't directly affect the rules enforced by the IRS. As one example, Internal Revenue Code Section 451 requires taxpayers to recognize income under the "all events" test when the company has a fixed right to receive the income and can accurately determine the amount. Ask your CPA how implementing ASU 2014-09 may create or increase the differences between the accounting rules you must follow and the applicable tax law.

Other projects

If your construction company typically works on installation or renovation projects, ASU 2014-09 will affect your accounting procedures differently. You should focus primarily on whether you can recognize revenue from materials or equipment separately from the installation work.

Making this determination won't always be easy, as specifics will vary based on the project. But, in a nutshell, you'll need to look at whether the materials or equipment has a standalone value to the customer.

To do so, ask yourself: Could the equipment be installed without customization by other contractors? Also, does it have retail sales value to the customer by itself? If the answers are yes, you'll likely be able to record the revenue separately. On the contrary, if you're performing specialized integration services that transform equipment or materials into a usable form, you probably won't be able to recognize the revenue separately.

Details, details

Assuming your company follows GAAP, ASU 2014-09 will challenge you with its detailed approach to revenue recognition. (Also note: Additional disclosures may be required under these rules.) Work closely with your CPA to prepare for the change and to navigate the new rules thereafter.

Getting on board with off-site construction

For decades, manufacturers made stuff in a factory while contractors worked on the jobsite. But the line between these two industries is blurring. More and more, certain projects are making use of the "off-site" construction model (sometimes also referred to as "prefabrication" or "modular"). And it's leaving many contractors wondering how and when to get on board.

Proponents and skeptics

Under the off-site model, building components or even completed structures are manufactured in a factory and then transported to the jobsite for installation. The process uses all of the bells and whistles of manufacturing — ultraprecise design software, robotics and logistics-based delivery — to create uniform pieces that can be built quickly and transported efficiently.

Proponents of the practice (often simply called "off-site") say it reduces construction costs and improves quality. The factory environment ensures complete control of the building process, with no deviations in quality because of more or less skilled workers and certainly no disruptions because of bad weather or accidents caused by human error. In turn, schedules can run more seamlessly and few, if any, unexpected expenses should be incurred.

Naturally, not everyone loves off-site. Many contractors and others in the industry frown on the cookie-cutter nature of prefabricated assets and structures. The distinctive touches and high quality of true craftsmanship cannot be readily duplicated by computers and robots.

Labor and technology

Whether off-site is good or bad — or, more likely, somewhere in-between — is a matter of opinion. But every contractor should know it's not going away. A 2014 report by the National Institute of Building Sciences found that 93% of companies in the architecture, engineering and construction industries had used off-site methods in the preceding year. Now, about four years later, the model's popularity is still surging for a couple of reasons.

First, the continuing skilled labor shortage is making off-site look awfully attractive to many construction companies. In a 2017 survey by the Associated General Contractors of America, 73% of construction company owners who responded said they're having difficulty finding qualified workers. Off-site doesn't eliminate the need for skilled workers; you still need someone to install and inspect prefabricated pieces or structures. But it does mitigate some of the labor required for initial construction.

Second, technology is driving the trend. Businesses and consumers are becoming accustomed to whipping out their smartphones and ordering whatever they want on demand and instantly. Off-site builders are making this a reality. For example, software giant Autodesk recently partnered with San Francisco-based Project Frog to create a cloud-based connected system that links architectural designs to industrial fabrication facilities. In other words, the platform will enable an entity to order up a building as easily as you can buy something on Amazon or eBay. This sort of high-tech approach is already being used by big names such as Starbucks and Marriott International.

Growing popularity

Will off-site someday eliminate the need for traditional "boots on the jobsite" construction companies? Probably not. The model tends to suit certain types of projects — such as health care facilities and, obviously, modular housing developments — where uniformity and repetition of design is standard. Still, its popularity is growing and may soon affect your market, if it hasn't already.

2018 surety outlook: No surprises, but slow industry growth

As a new calendar year unfolds, you may be wondering what, if anything, will change with your surety. The good news is that it doesn't appear that any big surprises will hit the bonding industry in the near future. Surety firms, as a whole, remain in pretty solid shape thanks to advanced risk management practices and a stable U.S. economy.

What may give your bonding provider pause are the expectations for slow construction growth coupled with your construction company's ability to handle its market.

Look ahead and around

As of this writing, construction industry projections for 2018 aren't bad but warn of slow overall growth. For example, in June 2017, the American Institute of Architects released its Consensus Construction Forecast. It's based on a twice-yearly survey of some of the leading nonresidential construction forecasters in the United States, including Associated Builders and Contractors and Dodge Data & Analytics.

The Consensus Construction Forecast calls for a slight decline in overall nonresidential construction growth from 3.8% in 2017 to 3.6% in 2018.

But, more strikingly, the data indicates a notable decline in commercial construction growth from 8.8% in 2017 to only 4% in 2018. On the bright side, institutional construction (such as health care and educational facilities projects) is projected to rebound from negative growth in 2017 to a 1.1% uptick in 2018.

On the residential side, some observers expect a similar trend. The 2018 Dodge Construction Outlook, produced by the aforementioned Dodge Data & Analytics, forecasts that single-family housing will go up 9% in dollars along with a 7% increase in units. Meanwhile, the report sees multifamily housing going down 8% in dollars and 11% in units. So, overall, expect reduced growth as the construction industry moves toward "a mature stage of expansion."

Communicate strategically

So let's get back to bonding. The prospect of slower national growth will likely have sureties more closely scrutinizing how construction companies are capable of handling their local markets. If your business focuses on nonresidential projects, you may have to compete harder for jobs. Homebuilders may also have to be more nimble in their efforts to win bids, depending on the needs of their localities.

Make sure your agent is aware of how your construction company plans to handle these challenges. A sound business plan that clearly indicates not only where you're going, but how and why, can help. When a construction company has a written, up-to-date plan, sureties think it's less likely to go off on a risky tangent.

Similarly, a contingency plan that shows how you'll deal with financial emergencies demonstrates your ability to remain cool under fire. Creating a disaster recovery plan that delineates your planned response for natural and manmade catastrophes is also a good move.

Keep the numbers strong

Continue to submit regular financial statements as well as updates on your current workload and backlog. Bonding firms tend to focus on equity and working capital. If you can demonstrate that you're managing cash flow and have enough working capital to see you through market slowdowns, you'll generally stay on a surety's good side.

Sureties also look for evidence that you've managed to stay profitable over the long term. By nature, the construction business has highs and lows — as the 2018 forecasts demonstrate. So if you can consistently show a steady history of profitability, your surety will more confidently believe that you can get through leaner times and may more willingly provide bonding for riskier jobs.

If yours is a newer company, bear in mind that a surety will sometimes want to review recently completed contracts as well as those in progress. It's looking to ensure that you're not taking on an unacceptable amount of risk.

Work closely

By and large, if you need bonding in 2018, you should be able to get it — assuming you've generally been able to do so in the past. But slower industry growth could mean you'll have to work a little more closely with your surety if business slows down and you have to step out of your comfort zone.

THE CONTRACTOR'S CORNER

How helpful are digital documents and e-signatures?

I'm a commercial electrical subcontractor. Recently, my company won a bid on a large job, and I estimated the time needed to complete our work at five months. My plan was to send progress billings every 30 days, but the general contractor required a signed lien waiver before remitting payment. The waiver process, however, was paper-based and sent through snail mail. Because of this, we had to wait an unreasonably long time to receive our first payment. Isn't there a better way to handle this?

Indeed there is. Construction companies are increasingly using digital documents and electronic signatures (or "e-signatures") to handle the entire lien rights process. (They're also using it for change orders and other documents.) When managed properly, this method can speed approvals and prevent unfortunate situations like yours.

Much faster

Traditionally, the construction industry is one built on paper — building plans, legal contracts, licensing forms and, yes, lien waivers. Of all of these documents (and others), lien waivers in particular tend to cause many headaches. In fact, they're often the last roadblock to many subcontractors receiving payment because of the time spent acquiring signatures, processing documentation and finally getting approval.

Digital documents equipped with e-signatures are changing all of this. When you can review and sign the lien rights waiver online, the form can be transmitted instantly and approved much more quickly. Providers such as Adobe (you probably know their PDFs) and PandaDoc, among others, provide this functionality at a reasonable cost.

Totally legal

In some sense, it's odd that more construction companies don't use this technology already, because so many service contractors already use card-swipe devices and e-signatures to accept customer payments. Perhaps the familiarity of paper documents for bigger jobs is hard to give up.

Another reason may be concerns over the legality. But, even here, you should be covered. E-signatures are generally considered lawful under two statutes: The Electronic Signatures in Global and National Commerce Act of 2000, a federal law, and the Uniform Electronic Transactions Act, which governs each state unless a comparable law is in place.

Long story short, every state has some sort of legislation in place legalizing e-signatures. There may be some limited exceptions in certain cases, so check with your attorney for specifics.

A favorable idea

As a subcontractor, you may not be able to deploy a system of digital documents with e-signatures unilaterally. But you can certainly recommend the idea to the general contractors you work with. Some may even have such functionality and just haven't offered everyone the option. The results, you'll likely find, should work in your favor.

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800 Red Brook Boulevard
Suite 300
Owings Mills, MD 21117

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