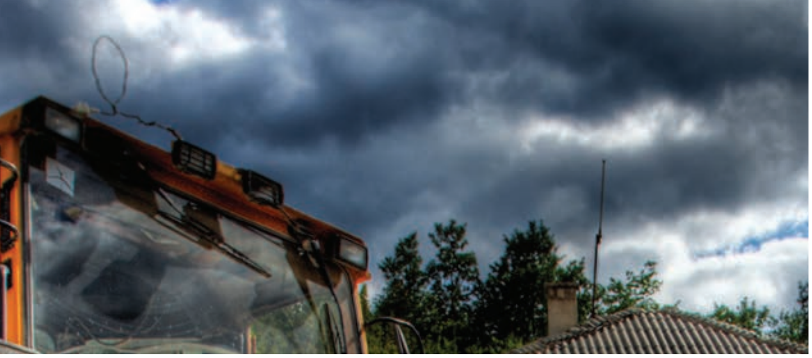
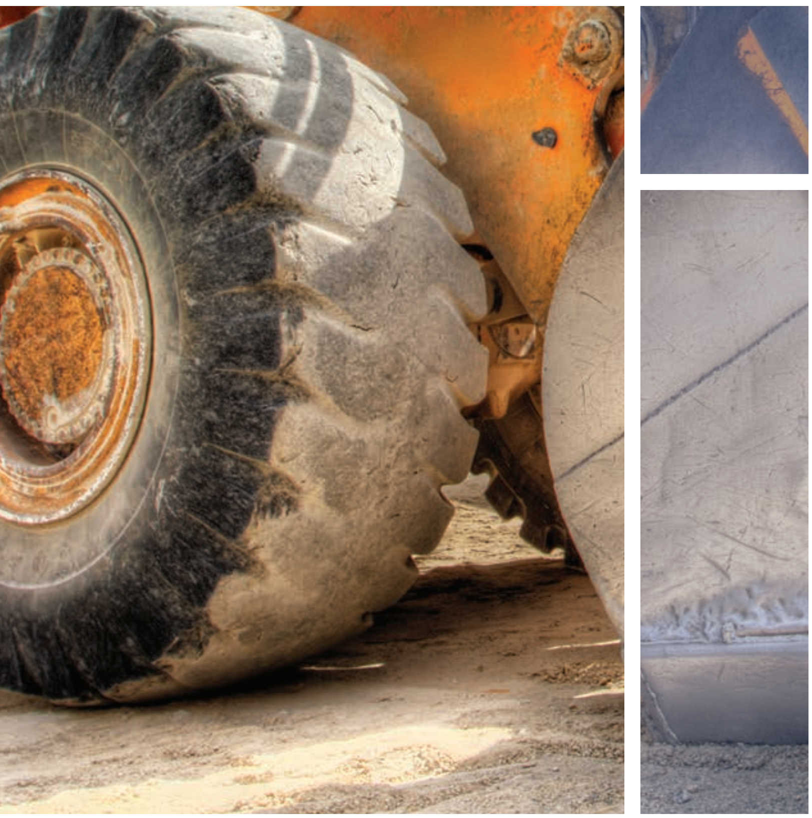


# CONTRACTOR

NOVEMBER/DECEMBER 2023



**How about that new lease-reporting standard?**
New accounting rules call for constant vigilance

**Reviewing your options for a business structure**

**OSHA's new recordkeeping rule will soon take effect**

**Embrace construction technology to sharpen your competitive edge**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# HOW ABOUT THAT NEW LEASE-REPORTING STANDARD?

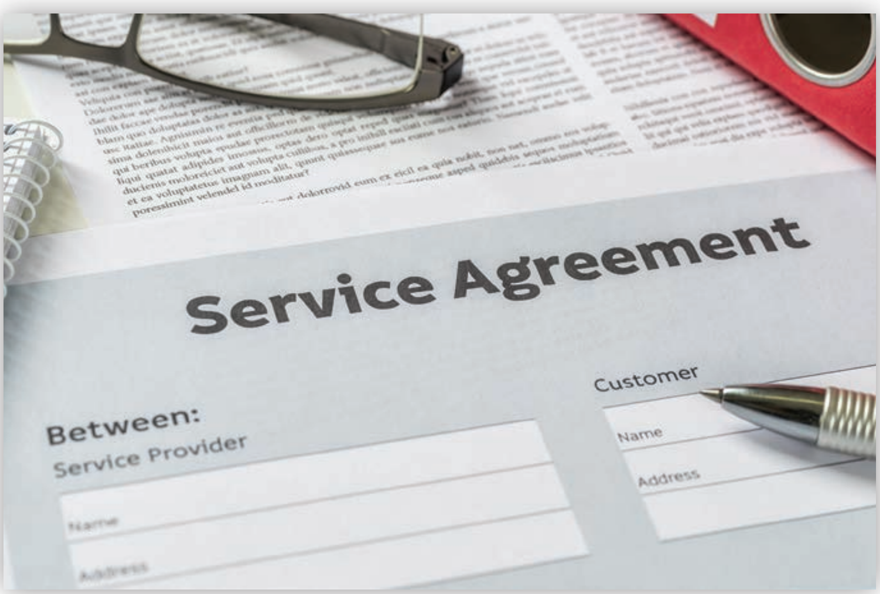
## New accounting rules call for constant vigilance

After some delay, the new lease-reporting standard from the Financial Accounting Standards Board — the organization that issues U.S. generally accepted accounting principle (GAAP) standards — kicked in for privately owned companies in 2022.

If yours is a GAAP-compliant construction business, you've presumably adopted the standard by now and operated under it for about a year. So, how's that going? Complying with the rules isn't a "one and done" deal. You'll need to exercise constant vigilance because the standard's rules affect some critical financial ratios for construction companies that lease property and equipment.

### Out with the old …

Under the previous rules, leases were classified as "capital" (sometimes also known as "finance") or "operating." Lessees reported capital leases on their balance sheets as assets and liabilities. Operating leases appeared on financial statements as a rent expense and disclosed in the footnotes.




The new lease-reporting standard — Accounting Standards Update (ASU) No. 2016-02, *Leases* (Topic 842) — changed the reporting significantly. It requires lessees to recognize all leases with terms of more than 12 months as right-of-use assets and corresponding lease liabilities, regardless of whether they're capital or operating. Lessees also must make additional disclosures about their leases.

Notably, the standard defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, a plant or equipment for a period of time in exchange for consideration (for example, rent). These "parts" of contracts are referred to as "embedded" leases.

Embedded leases can lurk in larger agreements that aren't ostensibly leases themselves. Examples include:

- Service or IT contracts,
- Advertising (such as billboards),
- Transportation and delivery services, and
- Joint operating agreements.

Under ASU 2016-02, you must separate the lease components from the nonlease components in such agreements to properly include the former in your lease assets and liabilities.

### Ratios at risk

Although many businesses (construction and otherwise) understood that the new lease rules would alter the presentation of their financial statements, some have been unpleasantly surprised by the changes to their financial ratios.

## NEW LEASE-REPORTING RULES COULD IMPACT YOUR TAXES, TOO

The new lease-reporting standard — Accounting Standards Update (ASU) No. 2016-02, *Leases* (Topic 842) — doesn't change how leases are treated for federal income tax purposes. But it could still affect your taxes in several ways. For example, the rules can increase or reduce financial ratios (see main article), which could have implications on so-called "transfer pricing."

Transfer pricing on intercompany transactions must reflect the pricing in an arm's length transaction for the same goods or services. The analysis of whether this requirement is satisfied generally involves financial ratios and profit-level indicators that could change because of the inclusion of operating leases as assets. So, a transfer price that previously met the arm's length standard may not under the new rules.

The rules also could lead to greater tax liability in states with franchise or other taxes that take into account net worth. If your construction business sees substantial increases in its reported assets because of the treatment of operating leases, its tax bill could increase as well. Work closely with your CPA to anticipate the impact.

Lenders, sureties and other interested parties often look to these metrics to assess a construction company's financial position. Negative shifts in your financial ratios could make it harder to obtain financing and bonding. You also might fall out of compliance with covenants in existing lending agreements. Stakeholders may particularly scrutinize your:

**Working capital ratio.** This is a measure of your company's liquidity and operational efficiency. Also known as current ratio, working capital ratio is calculated by deducting current liabilities from current assets. With long-term operating leases now recognized as noncurrent right-to-use *assets*, but current *liabilities*, your working capital may drop under the new standard.

**Debt-to-equity ratio.** This metric represents your financial leverage. It compares total debt on the balance sheet with the value of total equity. The ratio indicates the amount of debt you're using to finance your operations, as opposed to your own financial resources. The higher the ratio, the more difficult a company will find it to cover its liabilities.

The new rules increase total liabilities for companies with long-term operating leases, with no corresponding increase in equity, which pushes up the debt-to-equity ratio. This might suggest your construction business is at higher risk for financial troubles.

**Debt service coverage ratio.** This figure shows your company's available cash flow for covering current debt obligations. It's calculated by dividing net operating income by debt service (both principal and interest). Including long-term operating leases in debt service reduces the ratio and the amount of cash flow you appear to have to pay your current debts — that is, those due within a year.

### Onward we go

If you haven't already, dedicate the time and resources to identifying all your lease obligations — not just the obvious ones, such as construction and office equipment and real estate leases. As mentioned, you also need to unearth all those embedded leases tucked into otherwise nonlease agreements.

Once you have an initial inventory, plan on performing an annual review to keep it up to date and avoid violating the new lease-accounting standard. Your CPA can be an invaluable partner in this effort as well as someone who can help you better understand how GAAP rules affect your financial ratios. ■

# REVIEWING YOUR OPTIONS FOR A BUSINESS STRUCTURE

Whether you're thinking about launching a new construction business, or you're already in a leadership position with an existing one, how that entity is structured is a critical decision.

When a construction business grows to a certain point, it might be wise to change to a more complex structure to provide additional legal protection. Then again, if you're starting a new company and want to operate more nimbly, a simpler structure may be the way to go. Let's review the most common options.

## Sole proprietorships

The least complex way to do business is as a sole proprietorship. It's the easiest structure to set up and shut down. As the sole owner, you control all business decisions and report income and losses on your personal tax return.

The biggest risk of operating a sole proprietorship is that you're legally responsible for the company's debts and have no protection from lawsuits against the business. This puts your personal assets at risk.

## Partnerships

In a partnership, two or more people co-own the business. A formal partnership agreement should spell out how:

- Each partner's role and responsibilities are defined,
- Decisions will be made and disputes resolved, and
- Profits, losses and liabilities shared.

A good additional document to create is a buy-sell agreement, which stipulates how partners can buy out each other's shares in the company and how those shares will be valued.

Although the partnership itself doesn't pay federal income taxes, it must file an informational return. Individual partners then report their respective shares of profits and losses on their personal tax returns.

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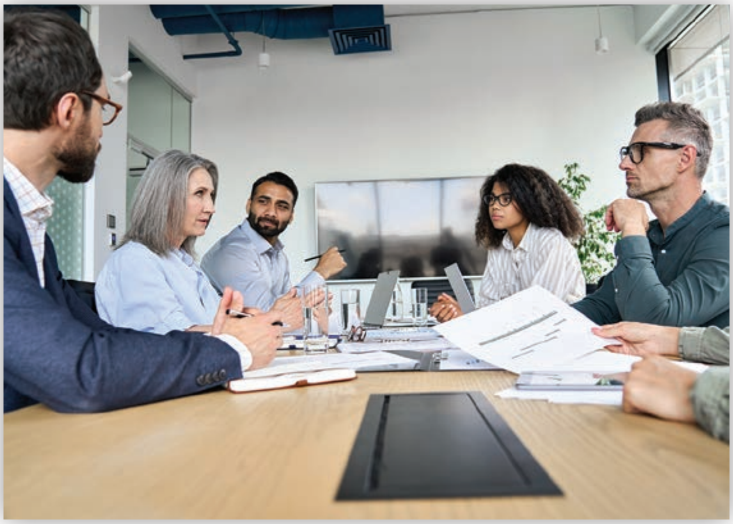
The partners of a general partnership are generally liable for the debts of the business. Under a limited partnership, at least one general partner assumes unlimited personal liability and makes all business decisions. Meanwhile, limited (or "silent") partners' liability is limited to their respective investments in the company.

## Corporations

A corporation is an independent legal entity, separate from those who own, control and manage it. Contractors often choose this business structure because it insulates them from personal liability — only the business's assets are at risk.

How a corporation is taxed depends on its type. Under a C corporation, profits are taxed at the corporate level and again when distributed to shareholders as a dividend or upon liquidation of the company. This "double taxation" is typically viewed as a downside. However, many construction companies (and other businesses) choose this structure because of its strong legal protections and potential for growth through stock sales.

Under an S corporation, you'll avoid double taxation. Individual shareholders are taxed directly for the profits and losses of the business, and distributions are based on ownership percentages. Generally, the corporation doesn't pay any tax. But you'll face restrictions on the number of shareholders and ability to raise capital.



### Limited liability companies

A limited liability company (LLC) combines the personal liability protection of a corporation with the tax advantages of a sole proprietorship, partnership or S corporation. Profits and losses are typically passed through from the company to its owners — who are called "members." Better yet, members don't have to allocate income proportionately to ownership as they do in an S corporation.

One potential complication to LLCs, however, is that they aren't governed by the same rules in every state. So, this form of ownership becomes especially tricky for contractors who work on projects in more than one state. The protection from liability in the state where you establish your construction LLC might be unavailable in regards to an out-of-state job.

The LLC structure is more flexible, however, because you can generally switch to a corporation down the road without dire consequences — though switching in the opposite direction may trigger a substantial tax bill.

### The right choice

When deciding which business structure to choose, or which one to switch to, you'll need to consider factors such as administrative complexity and cost, tax impact, state laws, and legal liability. Work with your CPA and an attorney to make the right choice. ■

# OSHA'S NEW RECORDKEEPING RULE WILL SOON TAKE EFFECT

In July 2023, the U.S. Occupational Safety and Health Administration (OSHA) published its final electronic recordkeeping rule. The rule expands current occupational injury and illness reporting requirements for construction and other designated high-hazard industries. It takes effect on Jan. 1, 2024.

### What this means for construction

The final rule mandates employers in designated industries with 100 or more employees to electronically submit data from the following forms annually:

- Form 300, "Log of Work-Related Injuries and Illnesses,"
- Form 300A, "Summary of Work-Related Injuries and Illnesses," and
- Form 301, "Injury and Illness Incident Report."

For eligible establishments with 20 to 99 employees, the rule will continue to require electronic submissions of only Form 300A data annually. Those with 250 or more employees that are required to keep records under OSHA's injury and illness regulation, regardless of industry, are also required to continue their annual electronic submissions of Form 300A.

OSHA intends to post the data gathered on a public website, but the agency says it won't collect and post identifying information about individuals. Although employers must include their company names, they aren't required to provide employee names and addresses; names of health care professionals; or names and addresses of facilities where medical care was provided away from a worksite.

## Data to gather

Under the rule, covered employers must make electronic data submissions to OSHA on March 2 of the year after the calendar year covered by each form. This means 2023 calendar year information must be submitted by March 2, 2024. To get ready, construction companies with 20 or more employees should:

- Determine which forms they need to submit based on company size,
- Review recordkeeping procedures and ensure best practices are being followed,
- Evaluate each injury or illness against OSHA guidance to determine whether it's work-related and must be recorded,
- Check applicable state law requirements; state agencies that enforce OSHA may have different recordkeeping rules, and
- Train employees on the new requirements and what needs to be reported.

If your construction business has been slow to digitize, you may want to speed up that effort now to enable electronic data transfer.

### Industry concerns

According to OSHA, expanded public access to establishment-specific, case-specific injury and illness data will allow employers, employees, labor representatives, job seekers, customers, researchers and the general public to make more informed decisions about workplace safety and health. But construction industry associations aren't so sure.

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In a press release, the Associated General Contractors of America stated that publicly disclosing the information "could result in the potential mischaracterization of a contractor's safety and health program in the absence of proper context."

Associated Builders and Contractors (ABC) has made similar statements. Ben Brubeck, ABC's Vice President of Regulatory, Labor and State Affairs, also warns that smaller companies may be negatively impacted: "The recorded information can easily be backtracked to identify specific injuries and illnesses, and thereby the medical information of individuals in the workplace, violating their privacy."

### Future uncertain

As of this writing, whether industry pushback influences OSHA's plan to publish companies' injury and illness data online remains to be seen. Publication of the data isn't part of the regulatory requirements of the final rule. ■

# EMBRACE CONSTRUCTION TECHNOLOGY TO SHARPEN YOUR COMPETITIVE EDGE

A recent survey of workers in various industries found that construction is viewed as "the least technologically proficient." The *2023 Yooz Survey: Technology in the Workplace* cites the industry's slow tech adoption rate and a lack of formal training for tech tools used on the job. (Yooz is a cloud-based software provider.)

The report suggests that, in an increasingly competitive landscape, the construction industry must work harder to demonstrate its commitment to new technologies to, among other things, attract younger workers. Here's how to set your business apart:

**Lean into it.** Carefully identify and prudently invest in technology that improves communication and collaboration, automates or simplifies tasks, increases productivity, and helps bridge labor gaps. Tools that may boost the efficiency of your workforce range from cloud-based document-sharing platforms to videoconferencing systems to more industry-specific solutions such as building information modeling, project management tools, drones, and equipment and vehicle telematics.

**Assess skill levels.** Survey your employees to determine their current level of technological proficiency. From there, pinpoint which skills, tools or software that you want employees to be proficient in — such as creating and reading digital blueprints, using project scheduling software, or conducting remote inspections.

**Provide hands-on learning opportunities.** Once you know your employees' aptitude for tech, you can tailor training to their specific needs. Today's experts recommend accommodating different learning styles, so offer a mix of training formats that includes in-person workshops, online courses, video tutorials, written guides and, if possible, one-on-one mentoring. Indeed, hands-on experience is often the most effective way to learn and retain new skills. Explore options such as virtual simulations, interactive workshops and on-the-job training.

**Offer refresher courses.** Technology evolves rapidly, so be prepared to offer regular training sessions to keep your team updated on new tools and techniques. Some construction businesses hold a monthly or quarterly "tech refresher" event for this purpose. Ensure that any technology training includes aspects related to safety and compliance. This could involve instruction on how to use safety apps, equipment tracking systems, or software for maintaining compliance with the latest Occupational Safety and Health Administration standards.

**Create an environment of feedback and support.** You can gain buy-in for your tech adoption efforts by showing employees how the right tools will make their jobs easier and improve the financial performance of the business. In turn, workers should feel comfortable asking questions and seeking help as they learn. Provide ongoing support through mentors or tech-savvy team members who can assist with troubleshooting. Meanwhile, monitor employee training and regularly evaluate whether your construction company is really becoming more tech savvy. As necessary, gather feedback and make adjustments. ■

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## About Wouch, Maloney & Co., LLP

Wouch, Maloney & Co., LLP is a regional certified public accounting firm with offices in Horsham and Philadelphia, Pennsylvania and Bonita Springs, Florida. The firm has provided closely held business and individual clients with a wide array of accounting services for over 30 years. Wouch, Maloney & Co.'s domestic, multi-state and international clients reflect a broad range of industries from real estate and construction to manufacturing, wholesale and professional service. The firm offers a comprehensive group of services including tax, audit and accounting, business consulting, estate planning, business valuation, litigation support and forensic accounting.

## Serving the Construction Industry

Wouch, Maloney & Co., LLP prides itself on its niche practice in the construction industry. The majority of our clients are involved in construction and we are adept at recognizing and solving problems common to that industry. For over thirty years, we have represented contractors along with commercial and home builders in Pennsylvania, New Jersey and Florida.

- We develop **relationships with lenders and bonding agents** and understand how to present your financial picture in their preferred format.
- We assist you in **keeping a close eye on debt, cash flow, profit margins** and other measures of financial health.
- We prepare **contracts in progress** schedules that management can understand which clearly illustrate gross profit, job costing and over/under billings per job.
- We have highly trained staff with **expertise in construction accounting** who are detail oriented, but who do not lose sight of the larger goal which is to provide our clients with quality services to meet their many financial needs.

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