CONSTRUCTION COMPANY MERGER AND ACQUISITION

Having accurate and complete financial information and displaying a transparent and credible assessment of a business's operations and finances will go a long way in protecting business value.

DUE DILIGENCE READINESS RECOMMENDATIONS AND BEST PRACTICES

DOUGLAS K. NICKERSON

The construction industry was significantly impacted by the economic downturn and collapse of the housing market in 2007, but it has made a resilient comeback.

Construction spending from 2007 to 2010 declined approximately 31 percent across the industry sectors of residential building construction and nonresidential building construction. However, since the low point in 2010, construction spending has increased an average of 8 percent each year, and through October 2015 construction spending is back to pre-recession levels; by year-end it will exceed levels the industry has not seen since before we entered into the last recession (see Exhibit 1).

With construction spending reaching its highest levels in nearly a decade, construction industry merger and acquisition (M&A) activity has become increasingly more attractive. Domestic construction M&A activity for the past five years has been relatively steady. However, M&A activity of construction-related businesses during the past couple of years has continued to gain momentum due to more attractive EBITDA

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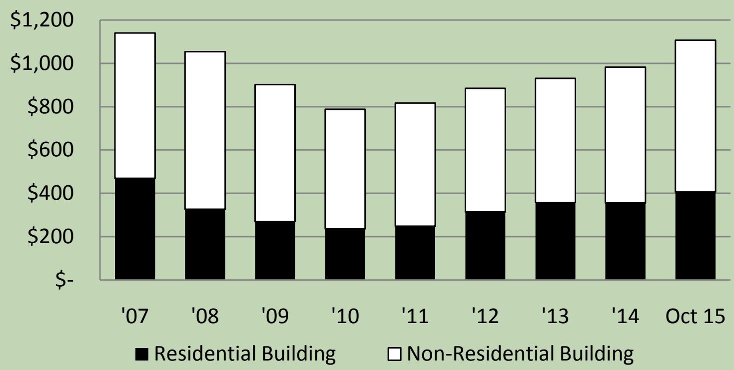
EXHIBIT 1 U.S. Construction Spending (Billions)



Source: Domestic residential and non-residential construction spending from the U.S. Census Bureau of the Department of Commerce. Annual spending for calendar years ending December 31, 2008 through 2014 and for year-to-date September 30, 2015.

(earnings before interest, taxes, depreciation, and amortization) and revenue valuation multiples, low borrowing rates, stronger balance sheets, and the impact of an overall economic recovery.

M&A process

Buying or selling a construction business could be one of the most significant events of a business owner's career. A business M&A transaction is a complicated and involved process that can more easily be navigated when the construction business owner has been properly prepared for the event. Without this proper preparation, there are various reasons that can potentially delay or terminate a transaction, including:

- unexpected accounting and tax issues previously unknown;
- difficulty in producing historic and current information and documents requested;
- related party or owner/family personal financial activities intermingled with the business's operations; and
- other surprises discovered during the transaction that should have been known by the seller.

Construction business owners who hold the desire to sell their company should be well prepared for the transaction, and depending on their current status of readiness, the preparation process can begin several years before the actual transaction. The preparation process should include:

- a careful assessment of factors and drivers that could potentially impact one's credibility as a business owner and the business value of the company;
- the evaluation of those key factors and drivers; and
- improving the key factors and drivers in order to maximize the business value.

In general terms, business value is the economic value of a business and can be determined based on traditional business valuation approaches, including the asset approach, the income approach, and the market approach.

Due diligence

A key step in an M&A transaction is the due diligence process, which involves the review and analysis by the parties to the transaction of the following key business activities:

- finance and accounting;
- information technology;
- operations;
- regulatory compliance; and
- health and safety.

For a construction business owner thinking of an M&A transaction, here are several key financial and operational areas to consider reviewing in advance preparation of the transaction to assess areas of risk, potential issues, and readiness and to maximize potential business value. The potential benefits of this readiness self-assessment include:

- improving the accuracy and completeness of financial information;
- improving the production and accessibility of requested documents and information;
- identifying potential EBITDA adjustments to the business value of the construction company;
- minimizing unknown surprises and issues discovered during the process; and
- providing a transparent and credible assessment of the business's operations and finances.

ALL BUSINESSES SHOULD ESTABLISH AND MAINTAIN WRITTEN POLICIES AND PROCEDURES FOR THEIR SIGNIFICANT ACCOUNTING AND FINANCE FUNCTIONS.

M&A readiness considerations

Policies and procedures. All businesses should establish and maintain written policies and procedures for their significant accounting and finance functions. A written accounting policies and procedures manual should describe the accounting procedures, indicate the party intended to perform those procedures, designate the reviewer and process for review and approval, and identify items required to be documented and retained. The policies and procedures manual should also provide guidance on the design and application of internal controls, improve efficiency of tasks, and help maintain consistency in accounting procedures and reporting. Procedures used to gain an understanding of the workflow task to be documented could include inquiry of employees, observation of employees' performance of procedure, and review of data, documents, and other information used in the process. Documentation may consist of manuals, process models and flowcharts, job descriptions, and forms. In general, the following items, although not considered to be all-inclusive, are considered by a construction business owner to be significant functions that should be documented:

- cash receipts and billing functions;
- cash disbursement and expense allocation functions;
- cash management function;
- contract bidding and cost estimating function; and
- financial close and reporting.

Once formalized policies and procedures are established and in place, it is important to monitor employees' compliance, review procedure design for efficiency and effectiveness, and make revisions where considered necessary.

Assets

In an M&A transaction, generally all — or only select — assets are acquired; therefore, we will address some of the more significant construction company financial assets.

Cash accounts. Cash and cash equivalents accounts should be reconciled to their respective financial institution account statement on a monthly basis. Reconciling and outstanding items should be reviewed monthly for appropriateness. Aged outstanding deposits in transit should be reviewed for collectability and aged outstanding checks issued should be reviewed as unclaimed property and remitted in accordance with applicable laws.

Accounts receivable. Accounts receivable customer balances should be kept current (within 30 to 60 days outstanding), which will indicate acceptable billing and collections procedures. An aged trial balance of accounts receivable should be prepared and reviewed on a monthly basis by the business owner. The aged trial balance of accounts receivable and other supporting documentation should be reviewed and cleaned up for items such as unusual customer credits, credit account balances, or significant delinquent balances. Outstanding balances over 90 days should be monitored closely, and efforts should be made to collect before the receivable aging makes its collection more difficult or impossible. An analysis of significant and specific uncollectible accounts should be prepared on a periodic basis, and accounts receivable should be adjusted for any potential estimated loss from uncollectible customer receivables.

Inventory. Construction companies often purchase significant quantities of common inventory that are stored in warehouses until required at the job site. A physical count and inspection of inventory on hand should be performed on a periodic basis. Inventory should be inspected for spoiled or damaged and obsolete items and then adjusted for any potential estimated loss due to inventory items being unusable.

Property and equipment. Property and equipment typically consists of vehicles, construction equipment, tools, office furniture, computers, and equipment used in the operations and general support of the construction business. A detailed inventory of all property and equipment should be maintained to include documentation of ownership, date acquired, acquisition cost, and other relevant information. A physical count and inspection of property and equipment should be performed on a periodic basis. Property and equipment determined to be damaged or obsolete should be removed from detailed inventory and financial records.

Construction activity in process. Revenue recognition issues for construction businesses are different than those of most other business entities. Most other business entities recognize revenues when a sale is consummated, goods or services are delivered to the customer, and collection of accounts receivable is probable. If this method was generally followed by construction businesses, then recognition of revenues would not occur until completion and delivery of the project. Current generally accepted accounting principles (GAAP) provide two methods of revenue recognition from construction contracts: the percentage of completion (PC) method and the completed contract (CC) method. Note that due to the recently issued revenue recognition accounting standards update, the revenue recognition rules for all entities, including construction businesses, will change starting with years beginning after December 15, 2018, and revenue will be recognized based on satisfaction of individual performance obligations. Under the current PC method, revenues, costs, and profits are recognized based on the contract progress. Under the current CC method, revenues, costs, and profits are recognized when the contract is substantially complete.

Generally, the PC method will be used by most construction business owners except in unusual situations. As such, there are some unique aspects of the PC method of revenue recognition that a construction business owner should understand and manage appropriately.

Contract agreement. The contract agreement is a concise document of all of the major contract terms, typically including the following:

- identification of the owner and contractor;
- description of the project;
- project pricing;
- list of all documents included in the contract;
- project duration; and
- signature of all parties to the contract.

Properly executed and endorsed contract agreements should be maintained with other construction project documentation, such as bid documents, general conditions of the contract, project plans, addendums to the plans, notice to proceed, change orders, and other relevant project information for all significant construction projects.

Change orders. The change order modifies the provisions of the original contract agreement and is utilized when facts and circumstances arise that create the need to document additions, deletions, or changes to the contract agreement after the construction project has commenced. The change order typically includes the following:

- the date;
- a description of the additional or deleted work or changes in the work to be performed;
- the revised pricing due to the change in work;
- estimated revisions to the construction project's duration; and
- any exceptions or objections to the purpose for the change order.

REVENUE RECOGNITION ISSUES FOR CONSTRUCTION BUSINESSES ARE DIFFERENT THAN THOSE OF MOST OTHER BUSINESS ENTITIES.

Properly executed and endorsed change orders should be maintained with other construction project documentation.

Backlog. Backlog is the amount of revenues that a construction business owner expects to recognize from remaining work to be performed on uncompleted executed contracts, including new contract agreements for which work has not yet begun. It basically represents the amount of contracted work in the pipeline. Backlog information on uncompleted contracts in progress, executed contracts not in progress, and bids and proposals in process should be maintained to provide an indication of future construction activity and revenue potential of the business.

CONSTRUCTION BUSINESS OWNERS SHOULD CONSIDER PERFORMING PERIODIC PROFIT GAIN/FADE ANALYSES ON ALL CONTRACTS IN PROGRESS AND COMPLETED, REVIEW THE RESULTS, AND RESPOND APPROPRIATELY.

Schedule of contract activity. The schedule of contract activity is the tool used under the PC method to calculate revenue recognized for the period. The schedule should include the following for all contracts completed during the period and all contracts in progress at the end of the period:

- budgeted total contract revenues and costs;
- prior period(s) actual revenues recognized and costs incurred;
- current period actual revenues recognized and costs incurred;
- estimated costs to complete the project work;
- progress billings since the beginning of the project work; and
- calculation of project overbillings or underbillings.

The schedule of contract activity should be prepared and reviewed on a monthly basis to ensure adequate construction project financial management and proper revenue recognition. There are some unique aspects of the schedule of contract activity that a construction business owner should understand and manage appropriately.

Estimating. The construction business owner's estimating ability is particularly critical in two areas: the initial estimates used in the bidding process, which will become the budgeted total contract revenues and costs, and the estimates of contract progress and costs to complete during construction activity. This estimating process is critical to the accuracy of the PC revenue recognition method calculation. Estimates represent the business owner's best approximation of the actual costs to complete the contract in progress before a cost-to-cost PC calculation is made to recognize revenue on a construction project. Poor estimating of budgeted contract costs at project inception or costs to complete the contract in progress can result in lower periodic and contract completion profits recognized. A history of significant or unexplainable variances between budgeted contract profit and actual contract profit upon completion of the construction project could indicate the business owner's inability to properly estimate and manage the project.

Profit gain/fade analysis. An analysis of a construction business owner's estimating process can generally be achieved through a profit gain/fade analysis. This analysis involves reviewing the trends in gross profit by individual construction project throughout the project's duration. Unusual variations or trends noted in the gross profit amounts or gross profit percentages over the course of the contract could be an indicator of poor estimating of costs and profits, project mismanagement, or fraud. Construction business owners should consider performing periodic profit gain/fade analyses on all contracts in progress and completed, review the results, and respond appropriately.

Underbillings/overbillings. Costs and estimated earnings in excess of billings on contracts in progress are considered underbillings and are assets of the construction business owner. Billings in excess of costs and estimated earnings on contracts in progress are considered overbillings and are liabilities of the construction business owner. Underbillings could indicate that the contractor has inadequate billing practices and that cash flows could be enhanced by improving his or her billing and collection procedures. Overbilling could indicate that the contractor is being overly aggressive on billing practices or that the customer is assisting the contractor in financing the project with cash flow advances. There are many other reasons that result in contract underbillings and overbillings; however, it is important to understand the specific reason under each contract and respond to it appropriately.

Liabilities

Liabilities, although not typically assumed in all M&A transactions, could have a material impact on the purchase price of the business; therefore, we will address some of the more significant construction company financial liabilities.

Accounts payable. Accounts payable vendor balances should be kept current (within 30 to 60 days outstanding) or within established payment terms to maintain good relations with vendors and to take advantage of cash discounts offered by vendors for timely payment. An aged trial balance of accounts payable should be prepared and reviewed on a weekly to monthly basis by the business owner, and payments should be made based on established cash disbursements policies and procedures. The review of the outstanding accounts payable should focus on items such as unusual vendor debits, debit vendor balances, or significantly aged vendor payables. Aged vendor payable balances over 90 days should be monitored closely and efforts should be made to satisfy the obligation before being sent to collections or adversely affecting the vendor relationship and the business's credit.

Accrued expenses. Accrued expenses are unpaid period business expenses that have been incurred but have not been recorded through normal transaction processes, such as the accounts payable module or the payroll module. Typical accrued expenses for a construction business owner are:

- salary;
- wages;
- employee benefits;
- commissions and bonuses;
- compensated absences;
- warranties;
- interest; and
- taxes.

Accrued expenses have an impact on the PC calculation and overall results of the business's operations and therefore need to be recorded in the period incurred. Because these expenses do not originate through normal transaction processes, it is important that management develop and maintain a list of these significant accruals. Standardized working papers should be developed that include the purpose, methodology and assumptions in the calculation, and any supporting documentation.

Lease obligations. Classification of lease obligations is based on the view that a lease transferring substantially all of the risk and reward of ownership should be capitalized and that all other obligations should be treated as operating leases. Currently, capital leases are recorded on the balance sheet and operating leases are recorded on statement of profit and loss of the construction company. A detailed schedule of all operating and capital leases should be maintained. The schedule should include the terms and conditions of the lease(s), including:

- location;
- lease start and end dates;
- monthly lease expense;
- security deposit;
- lease incentives;
- utility charges;
- escalations and other concessions;
- guarantees; and
- other pertinent information.

A spreadsheet calculating rent expense on a straight-line basis over the lease term, even if payments are not made on a straight-line basis, should be maintained for each operating lease obligation. A spreadsheet that documents both that the lease meets one of the four criteria for classification as a capital lease and the calculation of capital lease asset and liability and future amortization should be maintained for each capital lease obligation. Note that due to the recently issued accounting standards update on leases, accounting for leases will change for all entities, including construction businesses, starting with years beginning after December 15, 2018, and substantially all leases will be recognized on the balance sheet.

Contingent liabilities. A contingency represents an existing uncertain condi-

LIABILITIES, ALTHOUGH NOT TYPICALLY ASSUMED IN ALL M&A TRANSACTIONS, COULD HAVE A MATERIAL IMPACT ON THE PURCHASE PRICE OF THE BUSINESS.

tion or situation that, when ultimately resolved, will result in a financial obligation for the construction company. Typically, these items are not represented in the balance sheet of the construction company until the uncertainty is resolved, at which time recognition would occur in the company's financial statements. The business owner should maintain a detailed narrative of all potential contingent liabilities, such as legal, employment-related, environmental, income tax uncertainties, and guarantee/warranty obligations. For each contingent condition or situation, the narrative should include the following:

- a summary of the facts;
- the status of the contingency, possible outcomes, and the probability of the final outcome; and
- a financial estimate of the company's potential liability.

Related-party transactions. A related party is a person or entity that can control or significantly influence management or the operations of the business entity. Common examples of related parties include affiliated business entities and principal owners and members of management and their immediate families. Common examples of related-party transactions include:

- purchases or sales;
- services provided or received;
- leases;
- loans; and
- guarantees.

Related-party transactions are normal in the business operations of middle-market constructions companies. These transactions are of particular interest in an M&A transaction; therefore, it is important that the terms and conditions for all related-party transactions are documented and disclosed.

Conclusion

Whether or not your construction company is currently up for sale, being prepared and performing a readiness assessment will help protect the business value you have built up in your construction company over the years through your strategic business decisions, your good financial and operational management, and your dedication and hard work. The aforementioned best practices and readiness recommendations are important for a construction business owner to embrace and address now in order to exhibit good current business stewardship and to be prepared for future business growth and changes, such as a potential sale of the business. Having accurate and complete financial information and displaying a transparent and credible assessment of the business's operations and finances will go a long way in protecting business value. Additionally, it will make the process of navigating a business M&A transaction much easier and will reduce the potential delays and possible hasty termination of a transaction. ■