Construction Industry Advisor

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Simpler accounting option now available for leasing entities

Last year, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*. This guidance offers private companies a simpler way to account for certain related leasing entities. Construction businesses that adopt the alternative can avoid the potentially costly variable interest entity (VIE) analysis associated with these entities and need not consolidate these entities on their financial statements.

For contractors, excluding leasing entities from their financial statements can be advantageous. Most lenders, sureties and other financial statement users prefer to evaluate a construction company's cash flow and tangible worth on a stand-alone basis. Indeed, when presented with consolidated financial statements, many lenders and sureties demand supplemental consolidating schedules that essentially undo the effects of consolidation.

Background

Construction company owners often create separate legal entities to acquire real estate, vehicles or equipment. They then lease those assets back to the company. Separate entities offer a variety of tax, estate-planning and liability protection benefits but, in some cases, this strategy implicates FASB's VIE rules. These rules are complex, and we won't discuss them in detail, but here's a brief summary:

Under Generally Accepted Accounting Principles (GAAP), a company's consolidated financial statements must include any entity in which it has a "controlling financial interest." Historically, this meant the company owned more than 50% of the entity's voting interests. But in 2003, FASB adopted a VIE model under which a company may be deemed to have a controlling financial interest in an entity even though it lacks majority voting control. The VIE rules were added in response to a series of high-profile financial scandals involving off-balance-sheet debt arrangements using "special purpose entities."

ASU 2014-07 permits private companies to opt out of the VIE rules for certain leasing arrangements.

Essentially, a VIE is an entity whose value to a company *varies* with the entity's financial performance. In other words, the value changes depending on how well the entity performs. A company has a controlling interest in a VIE if it:

- Has the power to direct the VIE's most significant economic activities, and
- Participates in the VIE's economics by virtue of an obligation to absorb the VIE's losses or a right to receive its benefits.

In the construction industry, VIE treatment often arises in connection with separate but commonly controlled leasing entities. Typically, the construction company guarantees or furnishes collateral

for the leasing entity's debt, thereby assuming an obligation to absorb the entity's losses.

Reasons for the change

ASU 2014-07 permits private companies to opt out of the VIE rules for certain leasing arrangements. FASB determined that these companies generally form separate leasing entities for tax, estate planning and liability purposes — not to structure off-balance-sheet debt arrangements.

In addition, FASB found that most users of private company financial statements say that consolidation isn't relevant to them, because they focus on the company's cash flow and tangible worth on a stand-alone basis. In fact, users say, consolidation distorts a company's financial statements because the leasing entity's assets are beyond the reach of the company's creditors.

Before the ASU, construction businesses that prepared GAAP-compliant financial statements often were forced to go through the costly process of applying the VIE rules and, in many cases, to consolidate leasing entities on their financial statements. Companies that wished to present their financial results on a stand-alone basis had to disclose a departure from GAAP or incur additional expense to prepare supplemental schedules for their financial statement users.

FASB concluded that the benefits of applying the VIE rules under these circumstances didn't justify the additional cost.

Opting out

ASU 2014-07 permits a private company to opt out of the VIE rules with respect to a leasing entity, provided:

1. The company and the leasing entity are under common control,
2. The company has a lease arrangement with the leasing entity,
3. Substantially all of the activities between the company and leasing entity are leasing-related (including supporting activities, such as providing guarantees or collateral), and
4. The amount of any guarantees or collateral the company provides to the leasing entity doesn't exceed the initial value of the leased assets.

Proceed with caution when it comes to VIE rules

There are risks to choosing the private company alternative offered by the Financial Accounting Standards Board's Accounting Standards Update (ASU) No. 2014-07. (See main article.)

Some lenders and sureties, for example, may still want to see consolidated financial statements — even if they're no longer required by GAAP. And changing your accounting method may alter key financial ratios that lenders and sureties rely on, so it's important to discuss the potential impact with them first.

It's also important to consider your future business plans. For instance, if you opt out of the VIE treatment and later take your company public or sell it to a public company, you'll have to restate your financial statements for prior periods.

Businesses that opt out must provide certain disclosures about any leasing arrangements in their financial statements.

Should you opt out?

The accounting alternative offered by ASU 2014-07 is effective for annual periods beginning after December 15, 2014, and for interim periods within annual periods beginning after December 15, 2015, with early adoption permitted.

If your construction company is considering opting out of the VIE rules, be sure to consult your advisors, lenders and sureties first. Opting out may offer significant benefits, but it's not right for every contractor. (See "Proceed with caution when it comes to VIE rules" above.) ■

Succession planning

Will your buy-sell agreement work when you need it?

To ensure a smooth ownership and management transition from one generation to the next, all closely held construction companies should have a succession plan. And a key component of that plan needs to be a buy-sell agreement.

A buy-sell agreement provides for the orderly transfer of ownership and control when an owner dies, becomes disabled or leaves the business. It also creates a market for otherwise unmarketable ownership interests, providing a departing owner's family with a fair price and the liquidity needed to pay estate taxes and other expenses.

To work effectively, a buy-sell agreement must have a carefully designed valuation provision, which sets the purchase price for a departing owner's shares. If the agreement undervalues or overvalues the company's shares, it can result in unpleasant surprises, disputes or even litigation.

Consider your options

Most buy-sell agreements use one (or a combination) of the following approaches to set the price:

- Negotiation between the parties,
- Valuation by one or more independent professional appraisers (either at regular intervals or after a "triggering event," such as the death, disability or departure of an owner), or
- A valuation formula tied to book value, earnings or other factors.

To avoid ambiguity, the agreement should spell out the agreed-upon valuation criteria. Is the price based on fair market value, fair value, investment value or some other standard? Is it based on the value of a controlling interest or a minority interest? What valuation date should be used?

Engage an appraiser

Negotiation can be a cost-effective way to arrive at a price that's fair to all concerned — so long as the parties can reach an agreement. If they can't, litigation may be inevitable. One potential solution is to provide for a negotiated price but, if the parties are unable to agree within a certain amount of time, then bring in an independent appraiser.

Some companies use formulas based on earnings multiples, but they can be unreliable.

Independent appraisals near the date of a triggering event generally produce the most accurate results. A professional appraiser will scrutinize your company, taking into account the special characteristics that distinguish it from other businesses in the industry and drive its value. The disadvantage of this approach, however, is that it can be costly.

To avoid this expense, many companies develop valuation formulas and incorporate them into their buy-sell agreements. Formulas are inexpensive and easy to use, but they're also risky. Why? Because they become obsolete soon after

the buy-sell agreement is signed. Book value, for example, may approximate fair market value at the time a company is established, but it quickly becomes out of date as the company generates earnings and builds goodwill.

Case in point: Two business partners had a buy-sell agreement that set the price at net book value plus $50,000. When one partner died, the surviving partner was able to acquire the deceased partner's interest from his estate for just under $200,000 — even though its fair market value had grown to more than $11 million.

Some companies use formulas based on earnings multiples, but they also can be unreliable. A multiple of earnings may approximate a company's value at the time an agreement is signed, but it won't necessarily reflect the company's value over time.

Review your agreement

It's a good idea to review your buy-sell agreement periodically to ensure its valuation provisions reflect your construction company's current circumstances. This is particularly important if your agreement uses a valuation formula that's more than a year or two old. ■

Impressing your surety in an iffy economy

Contractors understand the need to look good in the eyes of their bonding providers. But with the ups and downs in today's economy, it can be difficult to demonstrate that you deserve a solid "thumbs up." So how can you impress your surety that your bonding capacity is all that it should be? Read on.

What a surety looks for

One of the first things surety companies want to know is that you're able to ride out economic storms. Anything you can do to remain profitable — from reducing your own indebtedness to improving your collections — will be particularly valuable in periods of economic uncertainty.

Your working capital and tangible net worth will likely sit near the top of any surety's list of critical attributes, as will receivables and debt. Obviously, you want to *increase* working capital

and tangible net worth, while *decreasing* past-due receivables and debt. In addition, sureties focus on backlog information for future billings and revenues.

A little debt will go a long way in influencing your surety's view of you. You need to show a healthy relationship between liquidity and debt, as sureties aren't comfortable with a contractor who's so heavily leveraged that virtually all revenue is going to pay off debt. To improve your standing, consider debt reduction strategies such as an equipment sale or leaseback arrangement.

Consistency and liquidity

Of course, sureties look for consistency as well as solvency. If you've had significant swings in monthly performance, try to eliminate them and be prepared to explain them. Your surety is likely to look at how you fund delays and retainage, as well as how you handle change orders. Sureties also look at profit fade on a job — particularly any fade exceeding 10% of projected gains.

In addition, though a surety wants to know you can finish a job, it also wants to know you have assets it can seize if you don't. Excessive prepaid expenses, shareholder receivables and inventory all will count against you. Cash, current receivables and a reasonable amount of inventory will work in your favor. Sureties are less enamored of property and equipment that aren't liquid — particularly if you have too much capital tied up in them.

Work in progress and more

Another important consideration for bonding capacity is work in progress. Sureties aren't looking for expert builders; they're looking for expert business people. They want some assurance that you use accurate estimates and consistent approaches, and that you can still complete what you're doing if you add more work to the schedule.

If you have multiple projects open, you may want to close a few to improve your bonding capacity. Also, review your charges. If you billed one owner $150 per hour for a backhoe and another owner $200 for the same piece of equipment, be prepared to explain why. If you're undercharging on some jobs, the surety may reason that you're undervaluing your work in progress.

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Sureties look beyond the numbers, too. They want to see a history of successful projects and work experience, an organizational leadership depth chart that demonstrates your ability to stay in business if a key leader leaves unexpectedly, a history of banking relationships, and a business plan that indicates you know where you're going and what you're doing.

Prove your worth

The one word that your surety wants to hear is "stability." So make sure you do everything you can to prove your worth. And, of course, get your financial advisor involved. He or she can offer tips on how you can keep your surety happy. ■

Use JPM to track productivity during jobs

Poor productivity can spell disaster for a construction project. Unfortunately, traditional measures of productivity are applied after the fact, so they do little to help contractors spot issues during a job — while there's still time to do something about it.

To help contractors monitor productivity during jobs, ASTM International (formerly, the American Society for Testing and Materials) developed its Job Productivity Measurement (JPM) standard. Adopted in 2010, the standard enables contractors to measure productivity throughout a job and address productivity issues as they arise. It also alerts contractors to changes in productivity rates, serving as an "early warning system" for potential productivity problems down the road.

Output vs. outcomes

Rather than focus on output — such as the amount of concrete poured — JPM looks at *outcomes*. Output measures the amount of effort expended or materials installed, with little regard for the quality of the results. It obscures unproductive activities, such as repairs, rework or out-of-sequence work.

JPM, on the other hand, analyzes work performed relative to *actual* construction put in place — that is, work product that's acceptable to the customer. By measuring outcomes based on the transfer of value to the customer, JPM offers a more accurate picture of productivity in terms of actual progress toward contract completion.

It also provides a more reliable method of measuring percentage of completion. By tying it to construction put in place, JPM allows a contractor to make progress billings based on value provided, regardless of the amount of cost incurred, which can improve cash flow. This method tracks nicely with upcoming changes to accounting rules, which tie revenue recognition to the completion of performance obligations.

Putting systems in place

To make JPM work, you must have systems in place to measure, in ASTM International's words, "observed completion of the project as accepted by the customer." You need to break down the contract into tasks, assign cost codes to each task and create a budget that assigns labor hours to each activity that contributes to the finished product.

In addition, when relying on regular reports from workers in the field, you must track the observed percentage of completion for all activities (typically, weekly). Then, you need to compare those results against the actual hours devoted to each activity.

Measuring productivity in "real time"

Errors, repairs, rework and inefficient processes hurt a construction company's productivity. Rather than discover these issues in a "postmortem," consider implementing JPM. By providing ongoing feedback on problems that hurt productivity, it gives you an opportunity to correct problems during the course of a job — enhancing your performance, cash flow and, ultimately, your profitability. ■

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