CFMA Building Profits

THE MAGAZINE FOR CONSTRUCTION FINANCIAL PROFESSIONALS

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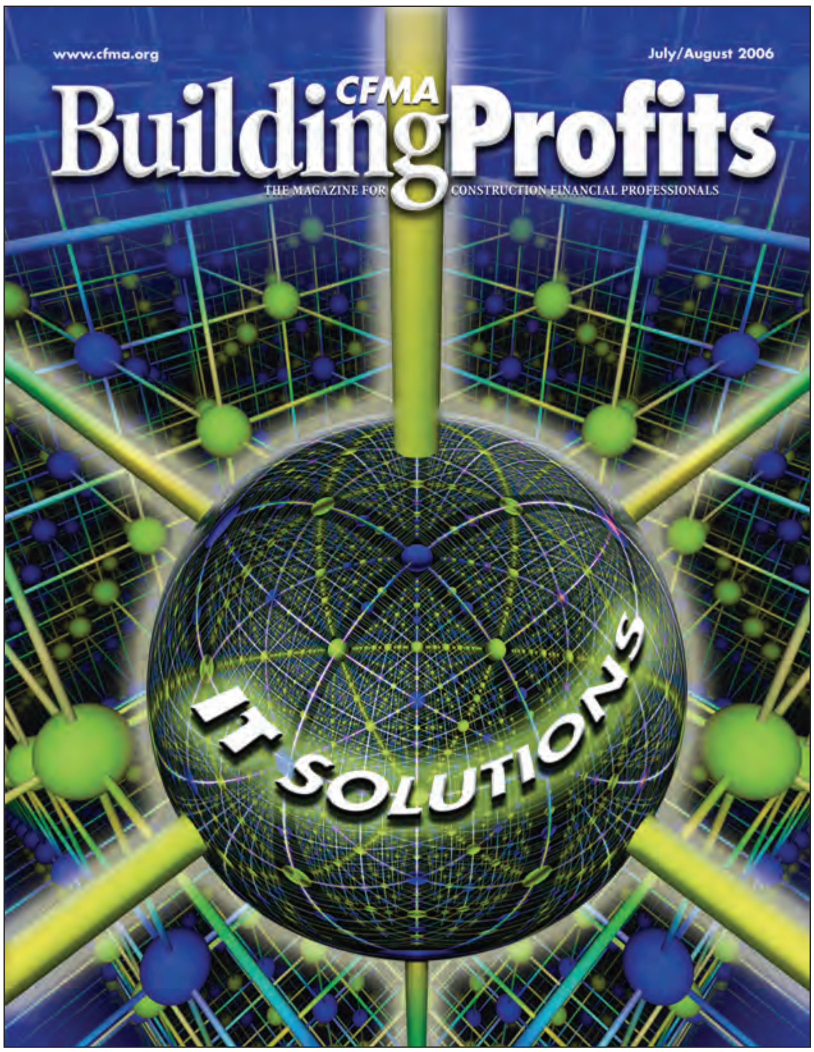

July-August 2006

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

The Source & Resource for Construction Financial Professionals

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FASB: An Update on Hot Topics & Emerging Issues

The Financial Accounting Standards Board (FASB) is discussing and evaluating various projects that may, upon final issuance, significantly affect the accounting and financial practices of contractors. To help CFMs adapt, we'll discuss some key FASB strategic initiatives and projects currently in the works and summarize their status.

FASB Strategic Initiatives

FASB has undertaken two ventures that will affect many contractors: the international convergence and private company initiatives.

International Convergence Initiative

FASB's single most ambitious initiative in recent memory is an effort toward international convergence, which is FASB's commitment to bring greater consistency to accounting pronouncements across the globe.

While world trade directly impacts only a few of the largest contractors in the U.S. today, it is likely to impact smaller businesses in the future. Following this pattern, it is only a matter of time before contractors of many sizes become involved in world trade. At that point, they will reap the benefits of FASB's work with other standard-setters to develop a more consistent set of global standards.

Unlike Fortune 500 companies, small businesses can't afford the finance and accounting staff necessary to track the unique accounting rules in every country where they may operate. As such, a more homogenous set of accounting rules throughout the world will help small businesses continue to operate efficiently, without the burden of tracking divergent accounting rules across the globe.

Private Company Initiative

On June 8, 2006, FASB issued an invitation to comment on *Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies.* This represents a substantial milestone for those individuals (including many construction professionals) who have worked to ensure that FASB becomes fully attuned to the needs of private companies. This proposal reflects a commitment by FASB to achieve greater input from private company constituents. FASB proposes to:

- Seek input specifically from those involved in financial reporting for private companies including users, preparers, and auditors.
- Present FASB members with potential alternatives for private companies when new standards are deliberated.
- Communicate FASB considerations of private company issues within the "basis for conclusions" sections of new pronouncements.
- Request exposure draft respondents to consider the impact of proposed standards on private companies.
- Consider the needs of private companies as it evaluates comment letters related to exposure drafts.
- Assign staff members with private company experience to current and future projects to help ensure that the views of private companies are considered throughout the entire deliberation process.
- Co-sponsor and co-fund an 11-member committee with the AICPA. The committee will develop recommendations for FASB that will help determine if there should be differences in accounting standards for private companies.

This proposal is available at *www.privatecompanyfinancialreporting.org.* CFMA's Accounting & Reporting Emerging Issues Subcommittee intends to present comments to FASB before the August 15, 2006 deadline, and we invite CFMA members to e-mail their views to Lynn Mitchell, Emerging Issues Subcommittee Co-Chair, at *lmitchell@cfma.org.*

FASB Projects

In addition to the strategic initiatives underway at FASB, several tactical projects remain on the Board's slate. Projects of interest include business combinations, financial instruments, fair value measurements, the fair value option, post-retirement benefit obligations, and insurance risk transfer.

Business Combinations

The business combinations project, titled "Business Combinations: Applying the Acquisition Method – Joint Project of the IASB and FASB," is a result of the international convergence initiative.

As written in the exposure draft, *Business Combinations – A Replacement of FASB Statement No. 141*, this proposed Statement would require all assets to be recorded and measured at fair value.

So, when an acquirer pays less for the business than the sum of the fair value of its individual assets, the acquirer will recognize the excess fair value in income. This differs from existing accounting rules that require the excess to be allocated as a *pro rata* reduction of the amounts that would have been assigned to the particular assets acquired.

This project is already beyond the exposure draft stage, but deliberations over unresolved issues continue. A revised exposure draft was released on July 5, 2006; a final pronouncement is expected during the first half of 2007.

Financial Instruments

The classification of instruments as liabilities or equity has been a very challenging project for FASB. Certain instruments, such as common stock and typical bank debt are easy to classify; others (such as the convertible instruments that have proliferated over the years) are more difficult.

FASB is also grappling with a measurement issue. The Board needs to determine how best to measure the recorded balance of each instrument – whether at cost, fair value, or some combination of the two.

During FASB's November 29, 2005 Board Meeting, an extensive chart was presented that detailed many of these multi-component instruments and their planned accounting treatment. The chart is available at *www.fasb.org/project/l&e_11-29-05.pdf*.

After its April 6, 2005 meeting, FASB issued its milestone draft, *Proposed Classification for Single-Component Financial Instruments and Certain Other Instruments*, which addressed Part 1 of Phase 2 of the project. When the exposure draft is issued for the entirety of Phase 2 (expected in 2007), it will likely replace FAS 150.

If you have any such financial instruments in your company, you may want to follow this project as it moves through deliberations.

Fair Value Measurements

The *Fair Value Measurements* working draft is in its final stages. FASB acknowledges that financial professionals wrestle with different definitions of fair value and that there is limited guidance for applying those definitions within GAAP. Moreover, that guidance is dispersed among many pronouncements that require fair value measurements. Differences in that guidance create inconsistencies that add to the complexities in GAAP.

In the working draft, FASB states that a single definition of fair value, in conjunction with a framework for measuring it, should increase consistency and comparability in fair value measurements.

FASB believes that the expanded disclosures about the use of fair value to re-measure assets and liabilities should improve the quality of information provided to users of financial statements. Expect this new standard to become effective for fiscal years beginning after November 15, 2007.

Fair Value Option

With this project, FASB's goal is to take a significant step toward comprehensive fair value reporting and move away from the historical cost approach. As outlined in the exposure draft, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115*, the project is broken into two phases. Phase 1 addresses financial assets and liabilities, which was the subject of the exposure draft. Phase 2 will address nonfinancial assets and liabilities.

According to the exposure draft, contractors can choose to apply fair value on an item-by-item basis in their financial statements. So, homogeneous assets and liabilities can be reported on different bases in the same financial statement.

The challenge will be for users, such as surety underwriters, to understand that financial statements will reflect a varying amount of assets or liabilities elected at fair value. Therefore, traditional surety measurement standards for risk assessment based upon debt to equity and revenue to equity or revenue to working capital may change based upon a "fair value standard."

Perhaps the most significant, and controversial, aspect of the standard is that debt instruments qualify for fair value reporting, and changes in fair value would include changes in a contractor's creditworthiness. A contractor that experiences significant financial difficulty could record earnings for the change in fair value of the debt simply because it is becoming less likely that the contractor can repay the debt. This change would artificially inflate earnings.

Lenders and bonding companies make decisions about extending (or continuing) credit largely based on a company's financial performance. To artificially inflate earnings, particularly at the expense of the credit provider, creates financial statements that risk becoming irrelevant.

On March 31, 2006, CFMA responded to the exposure draft of this project. Like CFMA, nearly two-thirds of the respondents who addressed the creditworthiness provision of the standard, opposed it. We hope that FASB recognizes the problematic aspects of the creditworthiness provision, particularly as it relates to financial statement users.

Postretirement Benefit Obligations

Also on March 31, 2006, FASB released its exposure draft, ***Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans an Amendment of FASB Statements No. 87, 88, 106, and 132(R)***. The most significant implication of the proposed standard relates to the method for measuring pension liabilities.

Currently, pension liabilities are measured based on the accumulated benefit obligation. Essentially, this actuarial measurement is based on current and historical levels of compensation. Under the proposed pronouncement, pension liabilities would be measured using the projected benefit obligation method, which takes anticipated future compensation increases into account.

Depending upon the plan's design, the difference between the accumulated and projected benefit obligations can be substantial – and adopting this change can result in a significant charge to equity. While only a small percentage of contractors sponsor their own defined benefit pension plan, the impact of this change on their financial statements could be severe, resulting in the erosion of bonding capacity.

The deadline for submitting comments on this exposure draft closed on May 31, 2006. In its response to this exposure draft, CFMA urged FASB to exclude private businesses from the requirements of projected benefit obligation measurement.

On June 27, 2006, FASB held two public roundtable meetings to discuss the Board's proposal. It is much too early to tell how FASB will proceed with this issue; however, in the exposure draft, the anticipated effective date is for fiscal years ending after December 15, 2006 – this calendar year-end.

If your company sponsors a defined benefit plan, begin speaking with your actuary immediately about the impact of this proposed standard on your financial statements; also consider contacting your lenders and surety.

Insurance Risk Transfer

This project is still in the relatively early stages. Issued on May 26, 2006, the invitation to comment requested input on bifurcating insurance contracts into two distinct components – the components that transfer risk (which is the portion that truly represents the insurance contract) and the component that does not transfer risk (which would then presumably follow "deposit accounting").

An example included in the invitation to comment contrasts the accounting for a company that self-insures its health insurance and one that assigns a traditional health insurance policy. In the example, the self-insured company must generally accrue losses upon incurrence, where externally insured companies recognize costs based on a level method of expense during the contract period, presenting the potential for significantly different income statement implications.

At this point, these are simply observations raised by FASB without any proposed changes in existing accounting. CFMA will evaluate the implications of this standard and will provide comments to FASB, if appropriate.

Conclusion

CFMA's recent comments to FASB are good first steps. Yet, there's much more work to do. To help ensure that FASB considers the needs of contractors when it deliberates broad-sweeping pronouncements, our industry must be appropriately represented when topics begin to emerge for discussion, and before they reach the exposure draft stage.

As we work toward earlier input on FASB issues, we ask for your comments and feedback. If you have a concern over proposed or existing accounting rules, please contact Lynn Mitchell at *lmitchell@cfma.org*. **BP**

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Ed is a longtime member of CFMA's Massachusetts Chapter. He also belongs to the AGC, ABC, AICPA, Massachusetts Society of Certified Public Accountants, Inc. (MSCPA), ASA, Surety Association of Massachusetts (SAM), and Construction Industries of Massachusetts, Inc. (CIM).

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CFMA & FASB

In 1983, just two years after the creation of CFMA, David Casey testified before the U.S. Treasury. Ever since then, CFMA members have lent their expertise to tax and accounting policy decision-makers when appropriate.

For example, CFMA and other key industry organizations outlined the adverse implications of FAS 150, ***Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity.***

In the original draft of that pronouncement, many contractors with buy-sell agreements would have had to re-classify significant amounts of equity as liabilities on the balance sheet. In response to the industry's input, FASB modified the provisions of FAS 150 to alleviate many of the adverse implications.

More recently, FASB has been busy, and so has CFMA. Through the Emerging Issues Subcommittee of the Accounting & Reporting Committee, CFMA has responded to exposure drafts on ***The Fair Value Option for Financial Assets and Financial Liabilities*** and ***Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.***

Help CFMA monitor, review, evaluate, and comment on proposed standards that could impact the construction industry. The Accounting & Reporting Committee is always searching for volunteers with a background in construction accounting and a willingness to help write comments to FASB. If you're interested, contact Brian Summers at *bsummers@cfma.org*.