



Beware: New consolidation rules may apply to you

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The "Enron effect" has finally arrived at the small- and medium-sized contractor and real estate company's doorstep: Responding to Enron's use of special-purpose entities to keep debt and other transactions off its financial statements, the Financial Accounting Standards Board (FASB) initially set out to require consolidation of these entities.

In contrast, the final interpretation is far broader in scope and, as you will see, will have an impact on contractors and developers. In 2003, FASB issued Interpretation 46 (and its revision), *Consolidation of Variable Interest Entities*.

FIN 46R interprets Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (as amended), which requires the preparation of consolidated financial statements when one entity holds a majority voting interest in another entity.

FIN 46R introduces the concept of a variable interest entity (VIE) and establishes new standards for determining under what circumstances consolidation of a VIE is required.

Consequently, the interpretation broadens the concept of control and will result in the consolidation of significantly more entities than under previous guidance.

Consolidating variable interest entities often reduces the net

worth of a company and will likely have a negative impact on its bonding capacity and borrowing ability.

The financial statements of many companies will first be affected in 2005; however, the current impact should be assessed now.

Specifically, FIN 46R's adoption may result in the consolidation of previously unconsolidated arrangements, such as:

- ✓ Leasing arrangements with another entity controlled by the company's owners
- ✓ Real estate partnerships or joint ventures
- ✓ Construction joint ventures
- ✓ Equity investments where

exposure to losses is limited by guarantees or by other means

What is a variable interest?

A variable interest is a contractual, ownership or other financial interest in an entity that changes with the value of an entity's assets or liabilities, including:

- ✓ Loans that create a residual interest in the borrower, such as subordinated debt with participation rights in net income or loss
- ✓ Leases that provide residual value guarantees

Any arrangement through which one entity provides financial support to another might be considered a variable interest.

New overtime rules take effect August 23

by Sarah Farrell, Kansas City,
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In April the Department of Labor (DOL) released long-awaited changes to the *Fair Labor Standards Act of 1938* (FLSA), revising salary and duties tests that determine who is legally entitled to overtime pay. The new rules go into effect August 23, 2004.

Currently, employees earning less than \$155 a week (\$8,060 annually) are eligible for overtime pay. Under the new rules, the

salary level will increase to include those earning less than \$455 a week (\$23,660 annually).

To determine whether employees earning between \$23,660 and \$100,000 are exempt from the FLSA overtime requirements, the new rules will replace the long and short duties tests with a standard duties test.

New sections added to the current regulations clearly state the employees of certain occupations are entitled to overtime, including blue collar, police, firefighter,

emergency medical technicians, paramedics and other public safety first responders.

The regulations also revamp duties tests that determine if an employee falls within white-collar exemptions to overtime.

The information in this article is correct at press time and employers must prepare to implement the new rules as they currently exist despite a proposed Senate amendment to new white-collar overtime rules.

For more information, contact your BKD advisor. □

What is a variable interest entity?

An entity is considered a variable interest entity if, by design, the entity's:

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by Jared Scott, Springfield,
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Two attractive retirement plans for self-employed individuals and/or employees of small businesses include simplified employee pensions (SEPs) and the federal Savings Incentive Match Plan for Employees (SIMPLE).

The two plans differ in many ways but have the following in common:

- ✓ No annual reporting requirement
- ✓ Cannot discriminate in favor of highly compensated employees
- ✓ All employees of a controlled group of business enterprises must generally be covered
- ✓ Individual retirement accounts (IRAs) are established for each participant
- ✓ Covered employees are immediately 100% vested and able to withdraw from their account at any time, subject to penalties and tax on early withdrawals
- ✓ Plans are established by completing a plan adoption agreement available from most financial institutions or by completing the appropriate Internal Revenue Service forms

The ways SEP and SIMPLE plans differ will obviously determine which retirement plan suits your situation.

SEP features

SEPs offer the following:

- ✓ Can be established by the sponsor's income tax return due date, including extensions
- ✓ Maximum contribution for 2004 is the lesser of 25% of compensation or \$41,000 (\$40,000 for 2003)
- ✓ Compensation used to compute an individual's allocation is limited to \$205,000 for 2004 (\$200,000 for 2003)
- ✓ Plan sponsor has discretion

2004 SIMPLE IRA Limits

Employees	Elective Deferrals	Employer Match	Total
Under age 50	\$9,000	\$9,000	\$18,000
Age 50 & over	\$10,500	\$10,500	\$21,000

over its contribution as long as limits aren't exceeded

- ✓ More liberal entry requirements may be adopted, at the plan sponsor's discretion
- ✓ Employees must be covered by a SEP if they match all of the following criteria:
 - Are at least 21 years old
 - Have performed services for the employer in any three of the previous five years
 - Earned at least \$450 during the current year

SIMPLE features

SIMPLEs stipulate the following:

- ✓ The employer generally can have no other retirement plan
- ✓ Employers who have more than 100 employees in the previous year who earned at least \$5,000 cannot adopt a SIMPLE
- ✓ Plan sponsors who exceed 100 employees in the future can continue to maintain a SIMPLE for a short time
- ✓ SIMPLE must generally be established no later than October 1
- ✓ The maximum eligibility requirements that can be imposed on an employee for participation in a SIMPLE include:
 - Must have earned at least \$5,000 in any (not just the preceding) two previous years
 - Be reasonably expected to earn \$5,000 in the current year
- ✓ Salary-deferral contributions must be deposited no later

Make it SIMPLE

than 30 days of the end of the month they are withheld

If you are a plan sponsor, you are required to contribute to a SIMPLE

with the following options:

- ✓ A matching contribution equal to 100% of participant salary deferrals of up to 3% of compensation
- ✓ The 3% contribution can be reduced to 1% twice every five years
- ✓ Alternative contribution is a 2% nonelective contribution to each participant, even if he/she did not make salary-deferral contributions
- ✓ A 2% nonelective contribution or 1% match require notice be given to participants before November 1 of the prior year

Note the employer match is limited to 3% of compensation:

- ✓ Compensation must be \$300,000 to receive \$9,000 basic maximum matching contribution
- ✓ Opportunity to reach \$18,000 or \$21,000 maximum contribution may be limited

Compare plans

Let's say you are a sole proprietor who employs only family members and are filing Schedule C. In your situation, here's how the plans compare:

- ✓ A SEP is advantageous for filers with large self-employment earnings
- ✓ A SIMPLE is advantageous for filers with small self-employment earnings and other sources of income, such as rent, and/or employ their spouse and children for nominal wages
- ✓ A SIMPLE is also advantageous if several employees and owners wish to contribute different amounts but do not want to establish a 401(k) plan

Salary deferrals to a SIMPLE can reach the lesser of 100% of compensation or \$9,000 before catch-up. To reach a \$9,000 SEP contribution, compensation of \$36,000 is required.

Beware!

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- ✓ Total *equity at risk* (see below) is not sufficient to permit it to finance its activities without additional subordinated financial support
- ✓ Equity investors as a group lack any characteristic of a controlling financial interest
- ✓ Ability to make meaningful decisions about the entity's activities through voting or similar rights
- ✓ Obligation to absorb the entity's expected losses
- ✓ Right to realize the entity's residual returns
- ✓ Voting rights of investors are disproportionate to their economic interests

Equity at risk - Initially, if an entity's equity is less than 10% of its total assets, it is presumed not to be able to finance its activities without additional support from parties involved with it.

Conversely, if an entity's equity is greater than 10% of its assets, it is presumed able to finance its activities.

Regardless of the 10% guideline, the following attributes must be satisfied to avoid consolidation:

- ✓ Equity is at least equal to the entity's expected losses
- ✓ Entity's equity equals or exceeds that of similar entities that operate without additional financial support
- ✓ Lenders are willing to extend credit to the entity without relying on anything but its existing equity

or simply a SEP

There is a crossover point where the compensation to compute the maximum SEP and SIMPLE contributions is equal:

- ✓ In 2004, the point is \$40,909 for participants under age 50
- ✓ In 2004, the point is \$47,727 for participants age 50 and over because the catch-up provision applies to SIMPLEs
- ✓ Above the crossover point, the maximum contribution available to the SEP will be greater
- ✓ Below the crossover point, the maximum contribution available to the SIMPLE will be greater

If you are considering a SEP or SIMPLE retirement plan, your BKD

tax advisor can help you determine which plan is right for you. □

new consolidation rules. . .

FIN 46R does not specify whether equity is measured at carrying value or fair value for purposes of this comparison, but many practitioners believe fair value is the appropriate measure.

When to consolidate

Investors should consolidate a VIE if they have variable interests that will absorb a majority of the VIE's expected losses.

If no investor is exposed to a majority of the VIE's expected losses, then it should consolidate if receiving a majority of the entity's expected residual returns. The investor who consolidates a VIE is the primary beneficiary.

The determination of a primary beneficiary occurs when the investor acquires (or transfers) a variable interest, or a change occurs in either the VIE's governing documents or contractual arrangements between VIE and variable interest holder.

Consideration of related parties - An entity that holds a variable interest in a VIE also must consider whether any of its related parties hold variable interests in the VIE and, if so, **combine those interests with its own** in determining whether it is the primary beneficiary.

FIN 46R defines "related party" more broadly than current accounting pronouncements. For instance, the following are generally considered related parties under FIN 46R:

- ✓ All officers and employees of the investor
- ✓ Another party that cannot finance its operations without subordinated financial support from the investor
- ✓ A party that received its interest in the form of a contribution or loan from the investor
- ✓ A party that has agreed not to sell, transfer or encumber its interests in the VIE without the prior approval of the investor
- ✓ A party that has a close business relationship with the investor

Related-party leasing transactions - Many construction companies separate real estate and/or equipment ownership from the operating business. The property is typically held by a separate entity controlled by the company's owners and leased to the company.

Under previous accounting rules, companies were not required to consolidate these leasing entities. FIN 46R will require consolidation of many of these entities because the related-party provisions attribute the variable interests held by the owner(s) to the operating entity.

So, even if the operating entity does not provide a guarantee of the debt or does not have any direct ownership, it will often be the primary beneficiary if the owner(s) provide such a guarantee, unless the leasing entity is determined not to be a VIE.

Consolidation by primary beneficiary

Except for entities under common control, a VIE's primary beneficiary is required to measure at fair values the assets, liabilities and noncontrolling (minority) interests of the entity on the date it first becomes the primary beneficiary.

Goodwill is not recognized; instead, the amount that would otherwise be reported as goodwill should be recognized in net income as an extraordinary loss.

Adjustments that result in negative goodwill should be allocated as a pro-rata adjustment to all of the noncurrent assets and—if there is excess after reducing those assets to zero—recognized as an extraordinary gain.

Effective dates

FIN 46R's provisions are effective immediately for entities with variable interests in VIEs created after December 31, 2003.

VIEs created between February 1, 2003, and December 31, 2003, are subject to the originally issued version of FIN 46 until FIN 46R is adopted.

For variable interests in VIEs created before 2004, the provisions are effective for nonpublic companies for years beginning after December 15, 2004.

What to do now

Immediately assess whether or not you have relationships with VIEs and if you do, must they be

consolidated in your financial statement?

Next, quantify the effect consolidation will have on your financial statements and consider how a negative effect will be perceived by those who use your financial statements, e.g., investors, lenders, sureties and regulatory licensing boards.

If you expect user perception to be negative, evaluate the possibility of restructuring these relationships before FIN 46R takes effect.

* * *

FIN 46R's complex provisions are difficult to apply and will result in consolidation of some entities when there is no direct ownership by an investor.

Significant judgment will be required to determine whether an entity is a variable interest entity, whether an interest should be considered a variable interest or if an entity controls a majority of variable interests.

If you believe you have variable interests in another entity, contact your BKD advisor. Now is the time to plan for implementation of this new standard. □

Check out. . .

Blueprint



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Part II: Planning & scheduling

Job site resource control

by Jerry Henderson, Bowling Green, jhenderson@bkd.com

Good job site resource control is essential to improving your bottom line and is the best way to improve profits.

Our March issue introduced readers to a three-part planning and scheduling series. Part I stressed the need for preconstruction meetings and plans for job site layout, scheduling and materials procurement. Part II addresses the importance of job site resource control.

Up labor productivity

Resources are comprised of the materials, equipment, job labor and subcontractors you use. Those who manage their resources the best can save between 5% and 10% in direct costs over the average contractor. These are savings that go straight to the bottom line and can often double your profits.

For example, in a typical eight-hour day, the average direct laborer will spend only four hours working productively. The quickest way to improve your profits is to improve the productivity of your labor.

On the job site, one of the biggest reasons for unproductive time is the time laborers spend waiting for materials to arrive or be

moved, for equipment to arrive or be repaired, for directions from their superintendent or for other trades to get out of the way.

On average, workers spend about two hours per day waiting; good job site layout and advance planning can help you cut that time in half and improve productivity as much as 15% per day.

Poor communication and corrective work rob productivity. Your job superintendent can help by planning three to five days ahead to ensure materials and equipment are delivered when needed.

Advance planning also alerts laborers to the kind of work they will be doing and helps them prepare for the job.

Use materials wisely & protect equipment

Wasted materials are expensive and the biggest culprit is rework that requires materials be removed, making them unsuitable for reuse. A lot of corrective work can be avoided with good planning and advance communication.

Theft is another culprit so make sure your materials are properly safeguarded outside of work hours.

Excess handling of materials also exposes them to damage and results in wasted labor time. Have a plan to ensure materials are deliv-

ered to the right spot on the job site and that they are moved only once for installation.

Avoid unscheduled equipment downtime by following a maintenance program, and don't use equipment after it starts to malfunction. In the long run, this will save you thousands of dollars.

Next, make sure all equipment is properly safeguarded from theft or vandalism on the job site and be sure it is adequately insured. Finally, implement a small tools equipment program to curb loss in this area.

Plan & communicate

To get the most from your

subcontractors, there is no substitute for good advance planning and communication.

This helps ensure your subcontractors will report to the job site with their materials and equipment, ready for work when they need to be there.

Effective communication will help laborers and each of the trades work together more smoothly and out of each other's way.

* * *

Reprints of the first article in this series are available from your BKD advisor, who also can provide more information about job site resource control or discuss a training session for your company. □

Bonus depreciation deadline looms

by George Storey, Springfield, gstorey@bkd.com

The deadline is quickly approaching to take advantage of a significant tax deduction. You only have until the end of 2004 to benefit from a temporary depreciation bonus to businesses for the purchase of new property.

This depreciation bonus offers the opportunity to deduct up front 50% of the cost of qualified


property—an especially good tax result when combined with a cost segregation study.

Eligible property is generally defined as new property and certain leasehold improvements placed into service by December 31, 2004. The deduction cannot be taken until the property is placed into service.

Appropriate tax planning is the best way to leverage this additional tax deduction. Contact your BKD tax advisor for more information. □

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