



Blueprint

Building Profits for Construction & Real Estate Companies

Understanding & Implementing FIN 46R provisions

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Editor's note: For reference, our summary of the provisions of revised Financial Accounting Standards Board (FASB) Interpretation #46 (FIN 46R), *Consolidation of Variable Interest Entities*, appeared in our July 2004 issue ("Beware: new consolidation rules may apply to you").

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FIN 46R is extremely complex, and portions of the standard are ambiguous, at best. Given its widespread implications, especially for the construction and real estate industries, you may benefit from lessons we have learned in helping clients implement the interpretation over the past year.

FIN 46R recap

FIN 46R interprets Accounting Research Bulletin No. 51 (ARB 51), *Consolidated Financial Statements*, issued in 1959 by FASB's predecessor, the Committee on Accounting Procedures.

ARB 51 requires consolidated financial reporting by an entity that holds a majority voting interest in another entity.

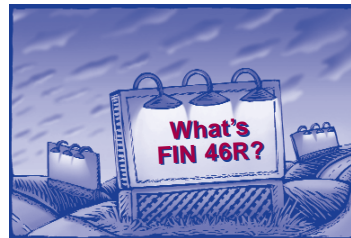
In short, FIN 46R introduces the concept of a variable interest entity (VIE), as well as a consolidation model based on variable interests that are contractual, ownership or other instruments that may require subsequent support of the VIE.

What's a VIE?

Variable interests include stock, members' units or partnership interests, as well as loans, leases, guarantees and other instruments whose values change with changes in the VIE's assets.

Because of this and the expanded rules of attribution for related parties and defacto agents (parties not normally considered

related, such as customers and banks), the interpretation significantly broadens the concept of control.



The party with the majority of variable interests in the VIE's gains or losses (with the primary focus on losses) is its primary beneficiary and is required to consolidate the VIE.

To apply the standard, first determine:

- ✓ If FIN 46R applies (there are a number of scope exceptions covered in the interpretation)
- ✓ If the entity is a VIE
- ✓ Who the primary beneficiary is

The primary beneficiary consolidates the VIE and makes required disclosures. The most difficult decisions involve determining VIE status. The interpretation lists criteria used to identify a VIE, principally that a VIE has:

- ✓ Insufficient equity to absorb the entity's expected losses without additional contribution of equity or guarantees by other parties, which may or may not include the equity holders

- ✓ Equity owners unable to make decisions about the entity's activities
- ✓ Equity that does not have the obligation to absorb the entity's expected losses or receive the entity's expected residual return

The interpretation does not distinguish a VIE from other business enterprises based on the nature of its operations; rather, it distinguishes a VIE based on the nature and amount of equity investment in the entity and the rights and obligations of the equity investors; however, the interpretation does have a scope exception for an entity that qualifies as a business.

Appendix C defines a "business" as a self-sustaining, integrated set of activities and assets conducted and managed for the purpose of providing return to investors.

It concludes that it must contain all of the inputs and processes applied to those inputs necessary

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for it to sustain a revenue stream by providing its outputs to customers.

Some legal entities in the construction industry may not qualify as a business under this definition because they were formed expressly for the purpose of completing a specific project and, thus, are not self-sustaining.

Similarly, if an entity has a limited life, this may indicate it is not intended to sustain operations for an extended period.

Nonetheless, even if an entity is deemed a "business," there are four significant inclusion criteria that could require it to be evaluated:

- ✓ The reporting enterprise (RE) and/or its related parties (RP) participated significantly in the design or redesign of the entity (joint ventures are exempted)
- ✓ Substantially all of the entity's activities involve or are conducted on behalf of a RE or its RPs
- ✓ The RE and its RP's provide more than 50% of the total equity and other subordinated financial support
- ✓ The entity's activities primarily relate to single-lessee leasing arrangements, securitizations or other asset-backed financings

Equity investment at risk

The interpretation states three possible ways for an entity to demonstrate equity is sufficient:

- ✓ It can finance its activities without additional financial support, for instance, by using nonrecourse financing
- ✓ It has at least as much equity invested as other entities that hold similar assets of similar quality in similar amounts and operate without additional subordinated financial support
- ✓ The amount of equity invested in the entity exceeds its estimate of expected losses based on reasonable, quantitative evi-

dence (expected losses are not the same as GAAP losses; this is complicated, can take considerable effort and is difficult to apply)

The interpretation presumes that an equity investment of less than 10% of the entity's total assets is insufficient; however, this is not a "safe harbor." Equity interests greater than 10% still require demonstration of sufficiency.

Decision-making ability

For an entity **not** to be considered a VIE, the holders of the equity investment at risk must have the ability as a group to make decisions about an entity's activities through voting or similar rights.

The interpretation is unclear about the nature of the decisions the equity holders must be able to make. We believe the equity owners should generally be able to make decisions that significantly affect the results of the entity's operations.

Therefore, if nonequity holders have substantive participation rights, the equity holders **do not** have substantive decision-making ability, and the entity is a VIE. In contrast to participation rights, *protective rights* do not generally trump substantive decision-making ability.

Expected losses & residual returns

The equity owners as a group are obligated to absorb the entity's expected losses if they occur. They also cannot be directly or indirectly protected (shielded) from expected losses or guaranteed a return on any portion of their investment from the entity (or other parties involved with it).

If equity owners suffer a total loss of their investment, the guarantees and other arrangements

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that protect the entity's lenders do not violate this condition.

In addition, equity owners must bear the exposure to the **first** dollar of loss in the entity. Equity owners cannot have their return capped through arrangements with the entity, with other variable interest holders or by the entity's governing documents.

However, allocation of losses among the equity owners would not violate this criterion as long as the equity owners as a group are exposed to the first dollar of loss.

Example: An entity is considered a VIE if it has a call option on an asset, *e.g.*, a fixed price purchase option in a lease, that, by design, explicitly caps the return to equity owners.

Anti-abuse clause

In an attempt to avoid consolidation, an entity may be structured with nonsubstantive voting rights. To prevent abuse the interpretation states an entity is a VIE when:

- ✓ The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, to receive the expected residual returns of the entity, or both
- ✓ Substantially all of the entity's activities either involve or are conducted on behalf of an investor that has disproportionately few voting rights (because the interpretation does not provide guidance for determining what constitutes "substantially all" of an entity's activities, BKD believes professional judgment is required and should be based largely on individual facts and circumstances)

Your company must base all the decisions this article covers on the facts and circumstances that exist on the date you become involved with the potential VIE.

These are particularly difficult decisions for enterprises in the

development stage. As a result, the interpretation provides that a development-stage entity is **not** a VIE if:

- ✓ It can be demonstrated the equity invested in the entity is sufficient to permit it to finance the activities it is **currently** engaged in
- ✓ Provisions in the entity's governing documents and contractual arrangements allow additional equity investments

Planning &

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

Clients often ask our help in evaluating ways to manage and control overhead. While careful overhead management is a component of financial success, it rarely substantially improves your profits.



The key for boosting profitability lies in better job planning, scheduling and project management.

Last year, we introduced a three-part planning and scheduling series, which identified ways to help you improve your profits.

We initiated the series in the April 2004 issue by covering the importance of preconstruction planning in the areas of job site layout, scheduling, materials procurement and preconstruction meetings.

Part II addressed the importance of job site management of materials, labor, equipment and subcontractors. This article

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In determining the equity's sufficiency at different stages, judgment should be used to determine the "activity the entity is currently engaged in."

Who consolidates VIE?

An enterprise is a VIE's primary beneficiary and, as such, is required to consolidate if it has a

variable interest (or combination of variable interests, including variable interests held by its related parties) that either:

- ✓ Absorbs a majority of the entity's expected losses, if they occur
- ✓ Receives a majority of the entity's expected residual returns, if they occur
- ✓ Both of the above

The enterprise that absorbs the majority of a VIE's expected losses trumps the enterprise that absorbs the majority of the expected returns.

A VIE can have only one primary beneficiary; however, every VIE is not required to have a primary beneficiary.

FIN 46R introduces new concepts and complex provisions. If

you are uncertain about your company's VIE status and/or consolidation, you are not alone.

Contact your BKD advisor to learn how this standard applies to you and for help in understanding and implementing it. □

scheduling Part III: managing your project to completion

appeared in the July 2004 issue.

Part III concludes this series with coverage of change order management, internal project meetings and job closeout.

Change-order management

At least once on every job, the owner, construction manager, architect or general contractor will approach you and ask you to perform work that is out of scope.

It might be wrapping up a phase that some other trade is scheduled to perform. You might be asked to relocate a panel or a wall because of a recent redesign, or differing site conditions might require modification.

Whatever the reason, requests like these are common, along with promises to your superintendent by the requesting party to "take care of you on this."

It's your superintendent's job to provide good customer service and keep the job on track so often times they oblige this request without any formalities.

Unfortunately, when you try to collect for your extra effort a few weeks later, it may become an exercise in futility: Often, the party that requested the work makes numerous excuses **not** to pay you.

So, how do you maintain good

customer service, keep the project on track and protect yourself from being taken advantage of in performing work that is out of scope?

- ✓ Develop a simple 3X5 form your superintendent can carry at all times
- ✓ Require the form be filled out and signed by the requesting party before you begin any out-of-scope work
- ✓ Even if the work is priced later, at least everyone agrees it has been requested
- ✓ Develop special job codes to capture out-of-scope time separately

This simple procedure can help eliminate up to 75% of the headaches and troubles associated with change-order management.

Project meetings

During a 40-minute college basketball game, each coach will typically call three or four timeouts. Add to this four to five media timeouts, plus a 15-minute half-time.

From the start to the end of 40 minutes of actual playing time, each team will have 20 minutes or more of instruction.

While you don't need to spend an hour in meetings for every two hours in the field, take an occasional timeout to assess the situa-

tion, evaluate adjustments and call some plays.

Timeouts—like those called in a basketball game—can change a project's momentum. Those that take place in the field allow the project manager, superintendent and crew to visually relate to the project.

Timeouts held at the office allow the project manager, vice president of operations and accounting personnel to review budgets, complete and update estimates, discuss problems and find solutions.

Ideally, hold job site meetings once a week and office meetings once a month.

Job closeout: let discipline be your watchword

The closeout phase is the only time you can truly measure the project's profitability. So, how do you avoid surprises when you reach closeout?

Throughout the job, shortfalls and mistakes can be hidden, but in closeout, all the skeletons come out of the closet. During the closeout phase, you must have a culture of discipline that rewards excellence and punishes excuses.

Support "no surprises" as your organization's standard because it

will help ensure discipline throughout the entire project. No surprises means problems are solved as they occur, not shelved for another day.

Set standards for closeout milestones and punchlist management to lessen all aspects of work occurring during this phase. Good job closeout begins with planning in the preconstruction phase and is managed throughout the life of the project.

Discipline in this area will substantially reduce profit fade, which, in turn, will improve your organization's overall profitability.

Once the project is complete, hold a debriefing with the project manager, superintendent, vice president of operations, accounting and safety to:

- ✓ Review the job
- ✓ Compare it against original expectations
- ✓ Identify learning experiences you can apply to future jobs and share with others in the organization
- ✓ Write a summary of the debriefing to be kept in the project file

Much of the information in this three-part series is just plain

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IRS sets sight at look-back calculation

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In a recent memorandum to its directors and managers, the Large and Mid-Size Business Division of the Internal Revenue Service (IRS) targeted noncompliance with look-back interest rules as an “emerging issue” in the construction industry.

This increased scrutiny will require taxpayers to pay more attention to how they calculate their look-back adjustments and whether it complies with the rules.

What's look-back?

Congress enacted the look-back rules to discourage taxpayers using the percentage-of-completion method on long-term contracts from underreporting contract

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common sense; however, all too often, common sense is not common practice.

To learn more about better job planning, scheduling and project management or to discuss a training session for your company, contact your BKD advisor. □

income in years the contract is still open.

The adjustment is made in the year a contract is completed. The taxpayer must hypothetically recalculate taxable income for every previous year the contract was open using final actual contract price and actual total contract costs.

The corresponding tax impact is recalculated based on the adjusted taxable income. If there is an increase in tax, then the IRS is owed interest. If the adjustment results in a decrease in tax, the taxpayer is entitled to interest on the overpayment.

Interest is calculated by using the federal overpayment rate as established in Internal Revenue Code §6621 and is compounded daily. The look-back adjustment and interest calculation is reported on Form 8697, *Interest Computation Under the Look-Back Method for Completed Long-Term Contracts*.

The look-back rules do not apply to certain contracts at the completion date when:

- ✓ Gross price of the contract does not exceed the lesser of \$1 million or 1% of the taxpayer's average annual gross receipts for the three taxable years before the contract is completed, and

- ✓ Contract is completed within two years of the contract commencement date

Also, certain taxpayers not required to use the percentage-of-completion method of accounting for tax purposes do not need to calculate look-back interest, including taxpayers with average annual gross receipts of less than \$10 million for the three previous tax years and certain home construction contracts.

Avoid common errors

In its memo, the IRS identified common errors taxpayers make when calculating the look-back adjustment:

- ✓ Improperly changing the interest rate quarterly rather than keeping it the same for the entire annual period
- ✓ Improperly computing look-back interest at the level of a flow-through entity when computing it at the owner level is required
- ✓ Cumulative changes to look-back taxable income and look-back tax liability for each re-termination year are not properly reported on Form 8697
- ✓ Form 8697 (interest refund claim) is improperly attached to the tax return to reduce current year's tax liability

Your options

Because the rules are complex, some taxpayers may have ignored or neglected look-back calculations in the past. As the IRS increases enforcement in this area, this may no longer be an option.

If you're in construction, determine if the look-back rules apply to you. If they do, making every effort to ensure compliance can help you avoid problems with the IRS. □

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