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Construction accounting update

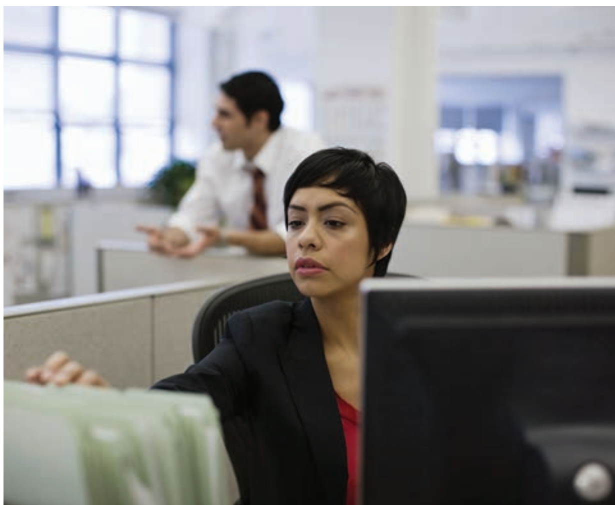
New guidance addresses certain leasing arrangements

Does your construction company follow Generally Accepted Accounting Principles (GAAP)? Have you formed a separate entity to buy equipment and lease it back to your business? Or have you formed an entity to buy facilities (such as your headquarters or a warehouse) to then lease back to you? If so, an important development this past March related to variable interest entities (VIEs) may affect your financial reporting.

The Financial Accounting Standards Board (FASB) issued new guidance that permits private companies following GAAP to, in some circumstances, elect *not* to consolidate the financial reporting from VIEs that lease property to them. The guidance is explained in Accounting Standards Update (ASU) No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*.

Is it a VIE?

GAAP rules state that, generally, a business must consolidate the financial reporting from an entity in which it has a controlling financial interest. One traditional way of identifying whether control exists is the voting interest model, under which the parent company simply owns a majority voting interest in the entity.



But there is another way: the VIE model. Here a company is deemed to have a controlling financial interest in an entity when it has:

- The power to direct the activities that most significantly affect the entity's economic performance, and
- The obligation to absorb losses, or the right to receive benefits, of the entity that could potentially be significant to the entity.

To establish whether the VIE model is applicable, a company must determine whether it has a variable interest in the entity and, if so, whether that entity is indeed a VIE. If the business has contractual, ownership or other financial interests in an entity that directly absorb or receive said entity's variability, an *explicit* variable interest typically exists. Then again, if the company absorbs or receives an entity's variability indirectly, it may be an *implicit* variable interest. The variable interest in a VIE can be either explicit or implicit.

If a variable interest in the entity does exist, the question becomes: Is it a VIE? To answer in the affirmative, one must generally be looking at a corporation, partnership or other legal structure used for business purposes that either: 1) doesn't have equity investors with voting rights, or 2) has equity investors that don't provide adequate financial resources to support the entity's activities.

What's the problem?

As mentioned, the new guidance addresses leasing arrangements. Previously established GAAP guidance required the lessee to determine whether it holds a variable interest in the lessor.

For example, one confirming factor might be if a lessee guarantees the lessor's debt. If a variable interest does exist, and the lessor is a VIE, the lessee must then establish whether it holds a controlling financial interest in the lessor under the VIE model. Should the two entities be under common control, the lessee will generally have to consolidate the lessor's financial reporting with its own.

The problem is that most users of private company financial statements dismiss consolidation of lessors under common control as irrelevant. Plus, consolidation distorts the lessee's financial statements — so much so that some users ask for consolidating schedules that enable them to *reverse* the effects of consolidation.

How can you qualify?

The new guidance seeks to mitigate some of these issues by allowing a private company to elect an alternative *not* to apply the previously established GAAP VIE guidance to a lessor. To use the alternative, three circumstances must exist:

1. The private company lessee and the lessor entity must be under common control.
2. The private company must have a leasing arrangement with the lessor entity.
3. Substantially all of the activity between the private company and the lessor must be related to the leasing activities (including supporting leasing activities, such as issuance of a guarantee or providing collateral on the obligations related to the leased asset) between those two companies.

In addition, if the private company explicitly guarantees or provides collateral for any obligation of the lessor related to the asset leased by the private company, the principal amount of the obligation at inception can't exceed the value of the asset leased by the private company from the lessor. (Other stipulations may apply — work with your CPA on all matters related to this guidance.)

And the upside?

Should you elect to apply the alternative, you'll need to do so for all current and future leasing arrangements that satisfy the conditions noted above. Again, the upside is much simpler reporting, because you won't have to consolidate qualifying VIEs with your financial statements. Some disclosures, however, may still be required. (See "Certain disclosures not eliminated under ASU 2014-07" above.) ☒

Certain disclosures not eliminated under ASU 2014-07

Should your construction company qualify, electing the alternative described in ASU No. 2014-07 (see main article) will simplify financial reporting. The alternative also frees you up from providing some disclosures about the variable interest entity (VIE) under Generally Accepted Accounting Principles (GAAP).

Certain disclosures, however, will still be required. For example, you'll need to disclose the amount and key terms of liabilities (such as debt, environmental liabilities and asset retirement obligations) recognized by the lessor entity that expose the parent company to providing financial support. You also must disclose a qualitative description of commitments or contingencies not recognized in the lessor entity's financial statements that may necessitate financial support from the parent company.

These disclosures are required along with any other GAAP-required disclosures about the parent company's relationship with the lessor entity. Ask your CPA for details.

4 ways to do project management just a little bit better

Contractors manage projects every day. But, as the construction industry evolves, so does your need to keep getting just a little better at project management. Let's run down four ways to gain a competitive edge when managing your jobs.

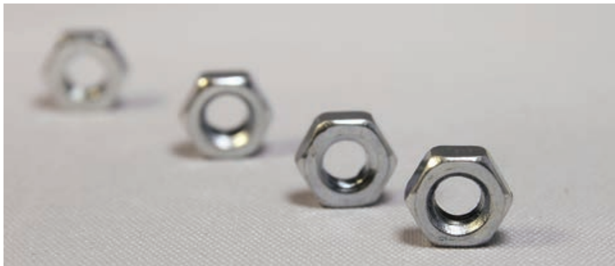
1. Formalize your preconstruction planning

A good way to start tightening up project management is to formalize your preconstruction planning. Doing so will help you get a better read on whether a job is even viable. For example, you might identify environmental hazards or discover a financially dubious owner.

When a project is viable, a formal preconstruction process should strengthen your odds of reducing costly, unexpected changes. The specifics of such a process will vary depending on company and project type. But just about every contractor should:

- Anticipate costs, including supply, equipment and labor costs,
- Identify and touch base with subcontractors and vendors, and
- Name the team members involved and define their responsibilities.

Also, be sure you're establishing clear channels of communication.



2. Standardize and simplify field systems

Every construction company has "field systems" that they use to perform job tasks. For instance, a concrete subcontractor will have standard approaches for forming the footings and slabs, installing bolts, testing for moisture, etc.

When a project is viable, a formal preconstruction process should strengthen your odds of reducing costly, unexpected changes.

Make a simple and concise list of your top 10 systems and clearly express — in writing — how they should be carried out. You want to develop standards that will be easily understood and can be verified with minimal dispute.

Now you've got something you can use not only when training new employees, but also when evaluating the performances of your project managers.

3. Provide ongoing management training

Historically, project managers have had to focus on traditional duties such as scheduling, contract and change management, and company-specific field systems — with some relatively basic financial management tasks thrown in. But expectations have grown.

Project managers at top-performing construction companies are now much more involved in the customer service side. In addition, they're expected to weigh in on strategic business decisions and have a wider grasp of financial metrics and trends.

In other words, today's best project managers aren't just focused on getting the job done. They're intent on fitting the job into your strategic objectives and guarding against outside risks (financial and otherwise). For them to be able to do all this effectively, you need to keep them properly trained.

4. Hold managers accountable

The word "accountability" must hold meaning when applied to your project managers. Start with their job descriptions, ensuring that the language is clear, current and constructive. Rewrite anything vague or unrealistic.

Also, look back at your company's recent history and pinpoint where accountability failures have occurred. Was it in budgeted vs. actual job costs? Field production results? Materials and equipment deliveries? Safety? Pinpoint danger areas for each project manager that they and you can double-check as jobs go along. For newer managers, make sure they understand the totality of their responsibilities.

Learning and growing

Project management is an evolving field. Today's construction industry isn't the same as yesterday's. And every job that comes along includes learning opportunities for everyone involved. ☒

Rev up revenue by contributing to a cost segregation study

In a construction business climate of changing IRS regulations and tough competition, contractors need to keep an open mind about ways to rev up revenue. Contributing your services to a cost segregation study remains a viable option. Whether you've participated in one in the past or are considering doing so for the first time, here's a quick review of the pertinent aspects.

Owner driven

Cost segregation is a tax strategy that allows building owners to maximize their current tax deductions by using shorter lives and faster depreciation rates for qualifying parts of their properties. A cost segregation study is appropriate for property owners who are going to construct, expand or remodel a facility — or who have recently completed such a project or purchased a property.

Property that qualifies for faster write-offs (such as decorative fixtures, security equipment, cabinets and shelves, and carpeting) is often lumped in as part of the building and depreciated over 27½ years for residential property or 39 years for commercial property. That's a long time for the owner to write off the full value of the building on his or her tax return.

A cost segregation study identifies structural components that owners can deduct much faster — typically over 15 years for land improvements and five to seven years for most equipment and

furnishings. This process may save owners thousands of dollars in the earlier years of owning or remodeling a property. For example, if $400,000 of assets were reclassified as seven-year vs. 39-year property, the owner's depreciation deduction in the first year would increase as much as 10 times, or about $50,000.

The cost segregation process may save owners thousands of dollars in the earlier years of owning or remodeling a property.

At this point, you may be asking why you, as a contractor, should care about cost segregation studies. The answer is simple: By helping to show owners how they can pay less income tax and, thus, increase their cash flows, you can get your construction company's name in the forefront of more owners' minds and perhaps turn these one-time opportunities into additional business.

Team based

A team of experienced professionals — including engineers, estimators, contractors, project coordinators and a CPA — usually performs a cost segregation study. This team examines a building's walls, floors, ceilings and plumbing, as well as its electrical lighting, telecommunications, heating and cooling systems and surrounding land, to identify the components that will qualify for accelerated write-off periods.

Computer cable, for example, can be depreciated over five years rather than 39 years. Land improvements, such as landscaping and fencing, qualify for a 15-year write-off period.

Timeliness optional

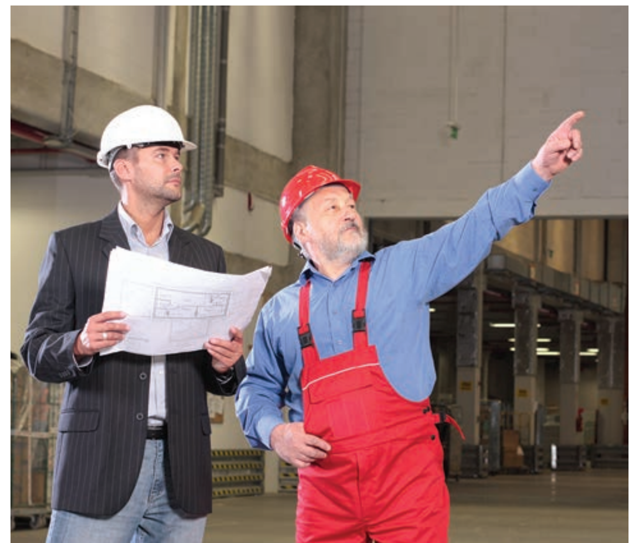
Encourage owners to initiate cost segregation studies sooner rather than later. The ideal time is when plans are being drafted to construct, expand or remodel a building. By tracking costs early, it's much easier for the owner to gather needed data when a project is completed.

Some owners, however, may want to conduct the study after their buildings are completed and occupied. This means that you and the cost segregation team will need to dig into archived files. Owners who start late in the game will still be eligible for identified tax benefits, assuming you can access the documentation they need. Detailed costs are vital to the accuracy of cost segregation studies.

Sometimes during or after a cost segregation study, property owners might identify opportunities to repair a given building or facility. If you encounter this situation, you might mention that, just last year, the IRS released final regulations on the tax treatment of expenditures related to tangible property. The regulations provide guidance on how to distinguish between capital expenditures and deductible business expenses when acquiring, producing, improving or performing incidental repairs and maintenance of property.

Detail oriented

Contractors, by nature, must be detail-oriented to ensure every specification of a contract is performed correctly. Cost segregation studies are but another chance to show off your attention to, and knowledge of, critical construction details. ☒



The Contractor's Corner

Is it *really* time to upgrade our accounting software?

One of my project managers has been pushing me to upgrade our accounting system. Granted, it's been a few years since we've done anything more than install security patches. But I don't want our cash flow to take an unnecessary hit. Then again, she's quite insistent that we need to be "integrated." How do I know whether it's really time for an upgrade?

Technology is tricky. Much of today's software is engineered so well that it will perform adequately for years. But technology is also getting better all the time. And if you're not getting as much out of your financial data as your competitors are, you could be at a disadvantage.

Rule of thumb

When making a major change to your accounting software, the sophistication of the system needs to align with the technological savvy of its primary users. Many construction companies buy expensive software only to have it gather dust on a shelf because the bookkeeper is resistant to change.

Every accounting system upgrade needs a champion. If that's your vociferous project manager, great. But she'll need to get a strong buy-in from the accounting department.

You'll also need to consider the costs involved. One interesting rule of thumb is that the salary of the system's primary user should be about double the total cost (including implementation and training) of the software itself.

So if, say, your bookkeeper earns between $30,000 and $40,000, and your new accounting package will cost about the same, you might be buying something that either never gets used or is never used fully. Like all rules of thumb, this one may not hold true in every instance. But it's an intriguing way to start thinking about the upgrade quandary.

Every nook and cranny

Because your project manager is also talking "integration," you'll need to think about your entire corporate culture. Integration, after all, is the concept of networking your accounting system with all of your other systems — estimating, job costing, etc.

So a successful companywide implementation will call for buy-in from every nook and cranny of your business — from project managers to HR. Generally, integration is advisable from an efficiency and accuracy standpoint. But ask yourself whether your business truly is ready for this undertaking right now.

An ambitious step

On a closing note, your hesitancy may hold the truth. Typically, if a construction company doesn't need any major accounting *process* changes, it probably doesn't need a major accounting *software* change either. But if upgrading both will help grow your business, it's an ambitious step worth considering. ☒

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