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CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

Dimensions

A CPA's Report for the Construction Industry

Spring 2017

Captive Insurance

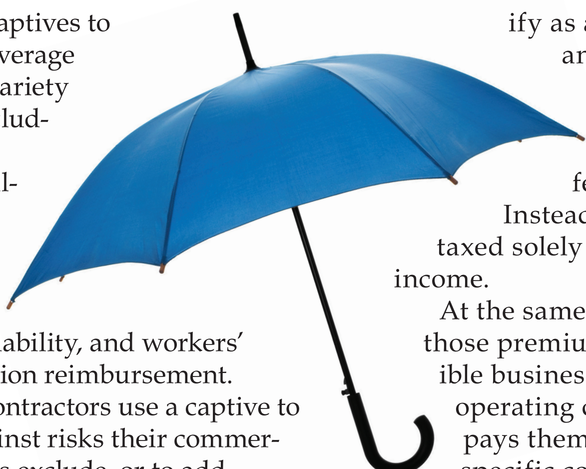
Three Recent Developments to Watch

In recent years, captive insurance companies have been attracting more and more attention in the construction industry. A number of companies have expressed interest in both the risk management advantages and potential tax benefits of forming a captive.

If you are considering forming a captive insurance company, or if your contracting firm already operates one, some recent developments could have a major impact on your decision.

Captive Insurance Basics

But first, a few captive insurance basics. A captive insurance company is a legally licensed, limited-purpose property and casualty insurance company formed to insure the risks of its owners. Contractors can form captives to provide coverage against a variety of risks including professional liability, errors and omissions, general and umbrella liability, and workers' compensation reimbursement.



Many contractors use a captive to insure against risks their commercial policies exclude, or to add coverage above their commercial policies' maximum limits. As a legitimate insurance company, the captive can directly access major reinsurance underwriters to cover these risks, without paying a commercial carrier's commission.

Another common strategy is to purchase high-deductible, low-cost coverage from a commercial insurer and then use a captive insurance company to provide so-called "first dollar" coverage for losses below the deductible.

Tax Considerations

In addition to risk management considerations, there are also some potential tax benefits that lead some companies to consider forming a captive. If a captive is properly structured and meets all the necessary risk-shifting and risk-distribution standards to qualify as a legitimate insurance company, the premiums it collects could be exempt from federal income tax. Instead, it would be taxed solely on its investment income.

At the same time, though, those premiums are a deductible business expense to the operating company that pays them, provided certain specific conditions are met. This potential tax benefit is obviously attractive to many companies, but it also has attracted the attention of the IRS, which has targeted certain types of captives as potentially "abusive tax shelters."

Current Developments

Most contractors that form a captive insurance company do so under the provisions of section 831(b) of the Internal Revenue Code. It is this section that makes it possible for a captive's premium income to be exempt from federal income tax.

This provision allows a captive to qualify as a legitimate insurance company — even if it does not meet some traditional insurance company conventions — as long as its gross premium income does not exceed $1.2 million annually and it meets certain other qualifications. But three recent developments could have a significant effect on this provision:

1. **Legislative changes —** The $1.2 million income cap was established in 1986 and didn't change for nearly 30 years. Congress raised the limit to $2.2 million starting this year, and it will be indexed to inflation from now on. This could open up the potential tax benefits to more companies. At the same time, though, Congress also added some diversification requirements that could discourage family ownership of captives.

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New Revenue Recognition Standard

Where Things Stand

It has been almost three years since the Financial Accounting Standards Board (FASB) issued its new revenue reporting standard. But there's still considerable work to be done before most contracting firms can comply with the new requirements.

Here's an update on where things currently stand, as well as a few things you can do now to get ready.

The Basics — What's at Stake

The new FASB standard — Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)* — represents an important change in U.S. generally accepted accounting principles (GAAP). Any business that is required to complete a GAAP-compliant financial statement for investors, lenders or sureties will need to adopt the new accounting practices to comply.

The update reflects a shift from what's known as "rules-based" accounting to a "principles-based" system for recognizing and reporting revenue on long-term contracts. The stated objective was to create a more consistent framework across all industries, so that those who read financial statements can make more accurate comparisons and evaluations. The reasoning was that revenue recognition should be based on the contract, not the industry.

To achieve this, much of the detailed, industry-specific revenue guidance that companies traditionally relied on was replaced by a set of broad objectives. But eliminating the industry-specific revenue recognition rules created considerable uncertainty in many industries, including construction.

Responding to these concerns, the FASB decided last year to delay its initial implementation deadlines. For publicly traded companies, the new standard will now go into effect for the first annual reporting period beginning after Dec. 15, 2017. For most companies, this means either calendar year 2018 or the fiscal year ending in 2019. For privately held companies, the standard goes into effect for the first annual reporting period after Dec. 15, 2018 — that is, calendar year 2019 or fiscal year 2020.

Contractors Task Force

To help companies apply the new standard to their specific industries, the American Institute of Certified Public Accountants (AICPA) formed 16 industry task forces. These task forces are responsible for developing an updated AICPA Accounting Guide on Revenue Recognition.

The Engineering & Construction Contractors Revenue Recognition Task Force identified a series of issues that are of particular concern in construction contracts. These include identifying the unit of account, estimation methods for claims and change orders, measures of progress, and accounting for uninstalled materials, among others.

The task force issued working drafts of proposed guidance on these issues last summer. After reviewing public comment, it will publish illustrative examples of how to apply the new standard. This guidance should be available in time to help companies meet the initial implementation deadlines.

Getting Started

While waiting for the task force guidance, there are several steps you can take now to get ready for the new standard. One important early step is to review your company's various revenue streams and determine if any of them result from service contracts or other types of business, such as distribution or manufacturing.

With the revenue streams broken down, you and your accountant can determine whether revenue should be recognized at a single point in time or over a longer period, which is likely to be the situation for construction work in progress. Next, you will need to select the proper input or output method for recognizing revenue — such as cost-to-cost, labor hours or some other acceptable method.

Once these questions have been determined, ASU 2014-09 spells out a five-step revenue recognition process:

1. Identify the contract with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Obviously, each of these steps involves considerable judgment and evaluation. This makes it critical to work closely with your accounting professional as you make the transition.

It's also important to remember that this new standard is one of two major rewrites of GAAP rules going into effect within the next few years. (See the facing article on the new FASB leasing standard.) So it's wise to be thinking now about the resources you will need in order to adapt your job costing and other accounting systems to comply.

Please contact us to discuss how you can start preparing for the new revenue reporting standard.

FASB Lease Accounting Standard

Anticipate Its Effects in Advance

The Financial Accounting Standards Board's (FASB) new lease accounting standard could have a significant effect on some commonly used financial metrics that are closely watched by lenders and bonding agents. Although the deadline for implementing the new standard is still several years away, contractors should be taking several important steps well in advance.

Changing Standards – Why It Matters

One of the most significant effects of Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)* is its potential effect on several key ratios — particularly the working capital and debt-to-equity ratios. Lenders and sureties typically require you to maintain these ratios at specified levels and to regularly submit financial statements that demonstrate compliance.

The potential problem stems from the fact that, under the new standard, all long-term leases will now be reflected on the balance sheet. This applies to all types of operating leases including leases for vehicles, equipment, office machines and office or warehouse space.

Under ASU 2016-02 you will be required to record the present value of scheduled lease payments for operating leases of more than 12 months' duration as a liability on the balance sheet. This liability will be offset by recording the "right-of-use" value of the property or equipment as an asset so the overall statement stays in balance.

Nevertheless, the changes will have an unequal effect on individual line items. As a result, your company could find itself out of compliance with required covenants — simply because the rules changed.

The Early Effects

For publicly traded companies, the new lease accounting standard will take effect for reporting periods beginning after Dec. 15, 2018. For privately held companies, the new standard goes into effect for reporting periods beginning after Dec. 15, 2019.

These dates are one year later than the comparable dates for the new revenue recognition standard (see the facing article on Page 2). So it might be tempting to focus on revenue recognition first and set aside the lease accounting changes for now.

In fact, though, now is the time to start focusing on the new lease accounting standard as well. This is especially true if you are initiating or extending a loan or credit line that will still be open after the implementation deadline, or undertaking a multiyear project that will require bonding past 2019.

Three Alternatives

Some large lenders and bonding agents are already adapting their contracts to reflect the coming changes. In other cases, though, it could be necessary for you to initiate the effort. If so, you and your lender or surety will probably choose one of three approaches:

1. Incorporate a "frozen GAAP" contract provision. This says that regardless of future changes in GAAP, future required financial ratios will continue to be calculated according to the GAAP rules that were in effect at the time the contract was executed.

2. Incorporate a contract provision that accommodates a transition to the new standard, but specifically excludes operating lease assets and operating lease liabilities when calculating key ratios for compliance.

3. Recalculate what the key ratios would be if the new standard were already in effect and use this calculation to establish new benchmarks.

There are pros and cons to each of these options, so it's important to discuss your concerns openly at the outset of any new credit or bonding agreement. The ultimate objective is to ensure there will be consistent rules and expectations throughout the duration of the contract.

Call us if you have more questions or concerns about upcoming accounting changes.

Captive Insurance

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2. **Notice 2016-66 —** Last November, as part of its intensifying scrutiny, the IRS issued a notice designating certain types of 831(b) captives to be "Transactions of Interest." As the notice is written, most captives will now have to file Form 8886, "Reportable Transaction Disclosure Statement," which could lead to IRS audits. The deadline for this year's filing is May 1, 2017.

3. **Pending tax court decision —** The IRS has not had much success against 831(b) captives in recent U.S. Tax Court cases, but a pending decision, *Avrahami v. Commissioner*, could change that. This case was argued before the court in 2015 and a ruling is expected sometime this year. Many industry observers expect the court's decision to provide more clarity into what is and is not permitted under 831(b).

In addition to following these ongoing developments, you should also remember an important principle: the decision to form a captive should never be made on the basis of tax considerations alone. Rather, the relevant business and risk management considerations should always be the primary factors driving the decision.

Please call us if you have questions regarding an existing or pending captive insurance arrangement.

IN 1944, Thomas Saltmarsh, Harold Cleaveland and Charles Gund pooled their talents and modest resources to form a partnership for the practice of accounting. The three founding partners soon established a client base that included large and small businesses, as well as commercial and governmental accounts. Their success was attributed to their guiding principles of honesty and integrity, accuracy and thoroughness, quality client service and, most importantly, the belief that service to the community is an individual as well as a corporate, responsibility.

TODAY, Saltmarsh offers a variety of services — from accounting and taxation to consulting — all based on the Firm's mission statement and core values. It is this philosophy, based on the principles of yesterday, that has helped the Firm grow to one of the largest locally-owned certified public accounting firms in the Southeast.

SALTMARSH CONSTRUCTION ADVISORS are here to meet the specific needs of contractors, home builders and related trades within the construction, real estate and development industries. Because we truly understand construction accounting and financial management, contractors and developers of all sizes and different trades rely upon our experience. Need assistance? Contact the construction advisors at Saltmarsh or call us today at 800.477.7458.

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New OSHA Electronic Reporting Requirement

A new workplace injury reporting rule from the Occupational Safety and Health Administration (OSHA) will directly affect many contractors. The new rule requires many employers to electronically submit information about workplace injuries and illnesses to an OSHA-operated website — and the deadline for the first submission is only a few months away.

Under the new rule, businesses with 20 or more employees in certain industries, including construction, must submit information from their OSHA Form 300A (Summary of Work-Related Injuries and Illnesses) to a designated OSHA website. The deadline for submitting the 2016 summary is July 1, 2017. Beginning in 2019, the submission deadline will move forward to March 2.

In addition, starting in 2018, all businesses with 250 or more employees will also be required to submit information from their OSHA Form 300 (Log of Work-Related Injuries and Illnesses) and individual injury and illness incident report forms (Form 301).

OSHA says it eventually plans to post each reporting establishment's specific injury and illness data online, although it pledges to remove any personally identifiable information. In announcing the plan, the agency said it believes that "making injury information publicly available will 'nudge' employers to focus on safety."

You can manually enter the required data into a web form on the OSHA website, or you can choose to upload CSV-formatted files or submit the data automatically from your own systems. You'll find more information about the recordkeeping and submission requirements at www.osha.gov/recordkeeping/index.html.

The new electronic reporting requirement is part of a package of new OSHA recordkeeping, reporting and anti-retaliatory rules that went into effect recently. We'll explore other elements of the package in future issues.

Please call us if you have questions about the new OSHA reporting requirements.