

# Accounting and Tax Issues for a Construction Roll-Up

By Robert A. Davidson, Daniel J. Vella, Bryan Hinton, and Stephanie Hurt

## Executive Summary

- A contractor must consider several accounting and tax issues when engaged in or seriously considering the possibility of selling to a consolidator or buyer. It is advantageous for the seller to have as much information as possible in order to anticipate how his or her company will be valued.
- Typical valuation models multiply the normalized earnings by a factor anywhere between four and six times to arrive at the valuation price. Multiples are driven by the stock market and what effect the acquisition will have on the consolidator's earnings per share, and what rate of return the investment will bring. The multiple can vary greatly depending on factors such as location and specialty. Publicly traded consolidators will usually pay a higher multiple than a private purchaser.
- Corporate acquisitions can be taxable, nontaxable, or partially taxable, and numerous formats are available for structuring corporate acquisitions to the benefit of both the buyer and seller, including taxable stock acquisition, taxable asset acquisition, direct merger or reorganization, forward triangular merger, and reverse triangular merger.

The construction industry is currently rife with roll-ups and consolidations. Many companies may be currently engaged or seriously considering the possibility of selling to a consolidator or buyer. To accomplish this, a contractor must consider several accounting and tax issues applicable to a construction industry roll-up:

- The valuation model being used by the consolidator
- The accounting information necessary to begin negotiations
- The method of accounting for contract revenues, billings, and costs
- Working capital and equity requirements
- Availability of quarterly financial information
- Closing balance sheet and short-period tax returns
- Operating differences for public entities
- Evaluation of the in-house accounting personnel

All of the foregoing items must be considered prior to the acquisition or sale of a construction company.

## Determining Value

A typical valuation model uses the average earnings before interest and income taxes (EBIT) for the last two years as the starting point to value a company. This amount is then adjusted for items such as job profit gain or fade, excess compensation paid to key employees, excess rent based on fair-market value in the geographic location, and other nonrecurring expenses and revenues to arrive at normalized or recast earnings. The typical valuation model will then multiply the normalized earnings by a factor anywhere between four and six times to arrive at the valuation price. Multiples are driven by the stock market and what effect the acquisition will have on the consolidator's earnings per share, and what rate of return the investment will bring. The multiple can vary greatly depending on factors such as

location and specialty. Publicly traded consolidators will usually pay a higher multiple than a private purchaser.

Usually five years of financial statements will be requested in order to determine what kind of growth and financial trends the company has experienced. Multiple years are typically used in pricing to help prevent an inflated price based on a spike period, which is not representative of a company's normal operating results. Additionally, the valuation model should always use a company's fiscal year-end and avoid using interim periods or annualizing interim periods. This is especially true for companies that rely heavily on their outside CPA to adjust their year-end accounts to be in accordance with generally accepted accounting principles (GAAP). Valuations based on a single year are risky and should be avoided.

A consolidator should always be consistent in the way companies are priced. Normally the cost-to-cost percentage-of-completion method using full-absorption costing should be used to account for jobs in progress. Other items such as depreciation methods and useful lives must be identical. It is advantageous for the seller to have as much information as possible in order to anticipate how his or her company is being valued. With this in hand, one can reasonably anticipate what the offer should be, and how the offer compares to others he or she may receive.

Consideration is given to the fair-market value of construction equipment, including average hours, condition, capacity and related factors. The valuation will be reduced if post-acquisition equipment purchases or repairs are anticipated. Accordingly, the value may be increased for significant appreciation.

A seller is usually expected to provide a company that is debt-free. Accordingly, all bank loans, lines of credits, stockholder borrowings, and other long-term borrowings will have to be paid off at or before closing. This may not be feasible in certain circumstances due to cash availability or contractor licensing requirements. It is best to work this out with the consolidator; however, any unpaid debt will usually be deducted from the acquisition price at closing.

### **Structuring the Acquisition**

Corporate acquisitions can be taxable, nontaxable, or partially taxable. In a taxable acquisition, the seller recognizes gain on the sale of its stock in the company or on the sale of the assets of the company. However, in a nontaxable or partially taxable acquisition, all or part of the gain is deferred. The character of the gain or loss in an asset acquisition is generally determined on an asset-by-asset basis, while the gain in a stock acquisition is generally capital in nature.

Numerous formats are available for structuring corporate acquisitions to the benefit of both the buyer and seller. These formats would include a taxable stock acquisition, a taxable asset acquisition, a direct merger or reorganization, a forward triangular merger, and a reverse triangular merger. Various strategies are available to defer or reduce the tax liability.

In a taxable stock acquisition, consideration is paid to the shareholders for the value of their stock. Gain or loss is recognized on the shareholders' individual income-tax return, and the corporation continues its existence. There is not a stepped-up basis in the assets of the company for tax purposes; therefore, costs, lives, and methods used for tax depreciation and amortization will carry forward. This will certainly affect the valuation.

In a taxable asset acquisition, consideration is paid to the target company for all or part of the assets, and gain or loss is recognized on the company's tax return. If the company is organized as an S corporation, the gain or loss will generally flow through to the shareholders' individual income-tax returns.

Various formats of mergers and reorganizations are available, which can result in taxable, nontaxable, or partially taxable situations. In most cases, the type of consideration received will determine the taxability of the transaction. Certain combinations of consideration (i.e., cash and stock) would result in a partially taxable transaction. Exhibit 1 shows the effect of form of consideration upon the taxation of the reorganization. Serious thought should be devoted to the choice of method of acquisition and the income-tax liability to the seller.

In addition to the prior-year financial statements, a consolidator will request other financial information, including completed and uncompleted job schedules for three to five years, job-cost subsidiary ledgers, aged accounts receivable and payable listings, accrued expenses, notes payable, lease agreements, equipment appraisals, and depreciation schedules. All of these schedules, ledgers or reports must reconcile to the general ledger for the periods being considered.

The first requirement of the consolidator is that the seller's internal financial statements be prepared using the percentage-of-completion method with full absorption costing. Job costs must include items such as depreciation, equipment costs, insurance, and labor burden. Use of any other method will require conversion to the percentage-of-completion method.

For consolidators, the most important area that will be addressed is the company's ability to estimate jobs. If the completed gross profit on contracts approximates what was originally estimated, then the adjustment to normalize earnings on contracts will be insignificant. However, if the completed gross profit on contracts fluctuates from what was originally estimated, then there is a good chance that the normalization of contract earnings will greatly affect the valuation of the company.

The consolidator will use the historical job schedules to prepare a job fade or gain analysis schedule. This analytical procedure will indicate how well company personnel can estimate job profitability. To normalize contract earnings, the completed gross profit percentage for each job will be used to look back and adjust the uncompleted estimated gross profit percentage for each job at the previous year end(s). Depending on the direction of the completed gross profit percent when compared to the uncompleted gross profit percent used at the previous year end, the company will either lose earnings or gain earnings from this procedure. In many cases, the estimated gross profit on uncompleted jobs is higher than the gross profit when the jobs are completed. When this occurs, the normalization of earnings will reduce the valuation of the company.

**Exhibit 1**  
**Effect of Form of Consideration Upon The Taxation of Reorganization**

<b>Type of Consideration</b>	<b>Taxation</b>
Cash and Other Property	Taxation
Stock	Tax-Deferred
Debt	Taxation

In addition, if the company happens to have successfully landed contracts that are highly profitable, the consolidator will want to recast the aforementioned normal gross profit to determine earnings for the valuation period. The reasoning is that this might have been a one-time occurrence on which the purchaser would not be willing to pay a multiple of earnings. Of course, the opposite point can also be made for unusual losses on jobs due to circumstances beyond the company's control; however, documentation will be necessary to prove the point.

Working capital is calculated by subtracting current liabilities from current assets. This number should be between five and ten percent of construction revenues. Equity is total assets less total liabilities and is the company's scorecard of how well it has performed since inception. Many consolidators require equity to be the higher of \$1 million dollars or ten percent of construction revenues. One should also remember that these amounts are normally calculated after the seller pays all debt. Knowledge of what is expected from the seller can assist with planning for items such as employee bonuses and paying off debt prior to the sale of the company. Accordingly, the purchase price at closing is increased or decreased for excess or inadequate working capital and equity.

### **Short-Period Tax Return**

The financial statements provided to a publicly traded consolidator must show a normal progression for the last eight quarters. This means that each quarterly balance sheet and income statement must include items such as percentage-of-completion, accruals for vacations and bonuses, and proper cutoffs. Many contractors are guilty of relying on an outside CPA to record numerous adjustments during the last quarter of the fiscal year. Consolidators do not want to consistently see losses in the fourth quarter due to adjustments that should have been recorded in earlier quarters.

It is imperative that the closing balance sheet and income statement be accurately prepared. The closing balance sheet will be used to measure working capital and equity requirements. This will also be the starting place for the preparation of the short-period tax return.

A short-period tax return must be filed through the date of acquisition. If the acquisition is structured as an asset acquisition and all of the assets are sold, the short-period return is the final return. As mentioned previously, the company continues its existence under a stock acquisition. In this instance, the short-period return is not the final return. If another acquisition structure is used, the short-term period return may or may not be the final return.

The due date of the short-period federal income tax return follows the same treatment as full-year returns. For example, the due date of the short-period return for a corporation acquired on March 8, 1999 would be June 15, 1999 (two and one-half months after the month of acquisition). Additionally, there are certain reporting requirements that should be attached to the short-period federal return depending upon which acquisition structure is used. In an asset acquisition, Form 8594 must be filed. In a stock acquisition, Form 8023 is filed in certain circumstances. Also, various statements under IRC Section 368 must be attached with the final tax return in certain mergers and reorganizations. Finally, state tax implications should be considered and short period state returns filed timely as well.

The monthly and quarterly reporting requirements for a publicly traded company are much more demanding than those of a privately held company. The accounting personnel must be knowledgeable about generally accepted accounting principles and timely closing of the monthly books. They must be able to properly accrue for all expenses, allocate job costs, prepare accurate job schedules, reconcile all accounts, and close the monthly general ledger in approximately ten business days. Most importantly, a public company must constantly think about quarterly earnings. The market prefers consistent quarterly earnings, which is generally difficult for even good contractors to maintain. Accordingly, backlog gross profit will be an important consideration to the buyer due to the impact on post-acquisition earnings.

Every consolidator must determine whether the company has an accounting staff capable of preparing financial statements in accordance with GAAP. This would include the capabilities for preparing a balance sheet and income statement in the manner discussed here. In some cases normalized earnings could be reduced in order to anticipate the hiring of additional staff that might be required.

### **The Trend Continues**

Consolidation is a trend that will not go away soon. For certain segments of the construction industry, consolidation may become almost mandatory to remain competitive. For certain owners, the benefits of selling offer the best exit strategy. Consolidation of construction companies requires careful consideration of many factors.