

Planning and Accounting for Joint Ventures

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Outline

- Definition
- Rationale
- Advantages
- Disadvantages
- The Agreement
- Accounting

Joint Ventures

Definition:

An arrangement where two or more parties pool their experience and resources to bid and/or perform projects they might not otherwise undertake



Joint Ventures

- Parties bid and/or perform the project as a single entity
- Create a new legal entity comprised of all parties
- All parties act as the prime contractor



Joint Ventures

- Combine items such as property, money, skill and knowledge to achieve a specific purpose
- Can be created for a single specific project or be permanent

Rationale

- Ability to complete a project that calls for distinct specialized scopes of work
- Eliminate project size issues – i.e., bonding, equipment and force requirements
- Reduce risk – sharing financial gains and losses

Rationale

- Opportunity to move into other geographic areas and gain new areas of expertise
- Ability to bid and complete larger, more complex projects

Rationale

- Opportunity to participate in projects that might otherwise be beyond capabilities
- Ability to qualify as a Special Interest designation such as Minority, Woman, or Veteran owned firms

Polling Question

- What is the predominant motivation for your clients to enter into joint ventures?
 - A. Able to bid on larger projects
 - B. Partner with Minority owned firms
 - C. Geographical issues
 - D. Project requires specialized knowledge

Advantages

- Financing
 - Projects are often beyond the financial capabilities (from both a bonding and working capital perspective) of a single contractor
 - Enables bids to be submitted on projects which otherwise a single contractor could not do alone

Advantages

- Risk
 - Opportunity to participate in large projects because the risks of these projects are shared by all participants

Advantages

- Specialized experience and abilities are combined
- Enables a pooling of talent, resources, equipment, etc.



Disadvantages

- Loss of Control
 - Contractors may be accustomed to managing a project without help from other parties
 - Unwillingness to compromise is a major reason for joint venture failures

Disadvantages

- Cannot accurately measure the knowledge and skills that each party brings to the joint venture
- No limitation of liability
 - Each member jointly and severally liable
 - In the event of a default by any member of the joint venture, the remaining financially responsible members are required to complete the job

The Agreement

- The rights and responsibilities of the parties involved can vary greatly based on the composition of the agreement
- Specific provisions of joint venture agreements may differ, but certain items should be addressed in each agreement

The Agreement

- Make-up -
 - A statement of the venture's purpose
 - The capital contributions to be made by each participant, such as cash, equipment, etc.
 - The rights and responsibilities of each participant
 - The bonding responsibility, if any, of each participant

The Agreement

- Make-up (continued) –
 - How profits and losses will be shared and when distributions are made
 - How decisions will be made
 - How the joint venture may be terminated

The Agreement

- Make-up (continued) –
 - Default provisions and remedies for default
 - In the event a member fails to contribute additional capital as needed, what effect does that failure have on the sharing of profits or on decision making

The Agreement

- Choice of Entity – Partnership vs. LLC
 - Partnership – absent additional legal filings, this is the default entity
 - Limited Liability Company – requires filing and creation with the state

The Agreement

- Choice of Entity – Partnership vs. LLC
 - In practice, the difference between the two is minimal as it concerns liability to the owners or sureties
 - Many owners and/or bonding companies will require that the individual members of an LLC sign guarantees, creating direct liability

The Agreement

- Bidding
 - The parties in the joint venture decide on how a bid/proposal will be developed
 - Often time consuming – simply requiring that both parties will “agree and submit” ignores numerous issues
 - What goes into the bid will have real effects when it comes time for performance

The Agreement

- Bidding – Issues to Consider
 - Bid Process – Will the parties cooperate on all terms of the bid or will each provide pricing for specialized areas to be combined later?
 - Bonding – If there are bid bond requirements – who will provide the bonding and on what basis?

The Agreement

- How is the work and resulting revenue or losses divided amongst the parties?
 - Two Options:
 1. Simple Statement
 2. Line-Item Division

The Agreement

- Simple Statement
 - Parties state their percentage interest in the joint venture
 - A more integrated/single-entity approach
 - Parties agree to split the final profit, after specific deductions, based on their percentage interest

The Agreement

- Line-Item Division
 - Revenue is defined in the contract with the project owner
 - Each partner assumes the profitability risk associated with their own work

The Agreement

- Line-Item Division (continued)
 - All partners are jointly liable for the completion of the total project under the terms of the contract with the project owner
 - No single set of books or records - each partner accounts for their own items of work individually

The Agreement

- Equipment Issues -
 - Will equipment be contributed by the partners?
 - If equipment is to be rented by the joint venture, the agreement should address the basis for the rental rates

The Agreement

- Equipment Issues (continued) -
 - For equipment acquired by the joint venture, the agreement should address how the joint venture will dispose of the equipment after the contract is completed

The Agreement

- Cash Distributions and Expense Reimbursements
 - Terms of the agreement regarding when, who, and how much the partners get paid
 - Timing of distributions can be a crucial element for partners who rely on returns for working capital
 - Which expenses will or will not be reimbursable to each member

Polling Question

- Have you seen an increase in joint venture activity?
 - A. Yes
 - B. No

Accounting

- Accounting Considerations When Establishing Joint Ventures
- Accounting by Venturers
- Disclosures
- Other

Accounting Considerations When Establishing JV's

- Form of Contributions
 - How Established
 - Types of Contributions
 - Accounting for

Accounting Considerations When Establishing JV's

- Accounting for difference between cost and underlying equity
 - Causes
 - Gains and Losses
- Internal Accounting & Administrative Issues

Accounting by Venturer

- The best accounting method for any given venture is that which most aptly reflects the transactions for the entity
- Methods
 - Cost Method
 - Consolidation (Full and Partial)
 - Equity Method
 - Combination of Methods

Polling Question

- Which accounting method for joint ventures is the most commonly used?
 - A. Cost
 - B. Consolidation
 - C. Equity
 - D. Combination

Accounting by Venturer

- Cost Method
 - Appropriate when the ownership percentage in the joint venture is less than 20%, in general
 - Initial investment remains unchanged
 - Earnings from the joint venture are recorded only when distributions/dividends are received

Accounting by Venturer

- Consolidation
 - Used if more than 50% of the joint venture is owned by the venturer
 - There are no reasons not to consolidate

Accounting by Venturer

- Consolidation (continued)
 - Control factor
 - For full consolidation, the complete amount of each asset, liabilities, revenues, and expenses of the joint venture is combined with amounts of the venturer

Accounting by Venturer

- Consolidation (continued)
 - Intercompany transactions and balances are eliminated
 - Minority interest would be shown between liabilities and equity
 - Minority interest income or loss would be an adjustment to consolidated net income or loss

Accounting by Venturer

- Consolidation (continued)
 - The use of partial consolidation is not in common use
 - Under partial consolidation, the venturer's proportionate interest in each asset, liability, revenue and the expense of joint venture is combined with amounts of the venturer

Accounting by Venturer

- Consolidation (continued)
 - No reporting of minority interest under the partial consolidation
 - FIN 46(R) (FASB ASC 810-10)
Consolidation of Variable Interest Entities

Accounting by Venturer

- Equity Method
 - Most common used method
 - Appropriate when the ownership percentage of the venturer is between 20% and 50%
 - Control factor

Accounting by Venturer

- Equity Method (continued)
 - Initial investment is at cost
 - Subsequent adjustment to investment to recognize the venturer's share of the income or losses of the joint venture

Accounting by Venturer

- Equity Method (continued)
 - Distributions/dividends will reduce the investment
 - Investment is shown as a separate line item on the balance sheet of the venturer

Accounting by Venturer

- Equity Method (continued)
 - Venturer's share of the joint venture income or loss is shown as a separate line item on the income statement
 - Losses in excess of investment
 - Expanded equity method

Accounting by Venturer

- Other
 - Mixture of methods
 - Most common is the equity method for the balance sheet and partial consolidation for the income statement

Accounting by Venturer

- Summary
 - The important issue in determining the appropriate method of accounting for construction joint ventures relate to extent of control and meaningful reporting

Accounting by Venturer

- Summary (continued)

Methods of Accounting Generally Used for Joint Venture

Types of Venture Ownership	Cost	Consolidation	Equity	Partial Consolidation
Corporate				
Over 50%		X		
20% to 50%			X	
Less than 20%	X			
General Partnership				
Over 50%		X	X	
20% to 50%			X	
Less than 20%			X	
Limited Partnership				
Over 50%		X	X	
20% to 50%			X	
Less than 20%	X			
Undivided Interest				
Over 50%		X		X
20% to 50%				X
Less than 20%	X			

Polling Question

- What additional financial support or commitments will allow an equity method investor to report losses in excess of initial investment amount?
 - A. Loans to investee
 - B. Advances to the investee
 - C. Investment in investee debt securities
 - D. All of the above

Disclosures

- Disclosures about the JV in the venturer's financial statements should include the following:
 - Name and ownership percentage of each significant joint venturer
 - Important provisions of the joint venture agreement, including any resulting liabilities or contingent liabilities

Disclosures

- Disclosures about the JV in the venturer's financial statements should include the following (continued):
 - Joint venture financial information in summary form, if significant
 - Intercompany transactions, pricing, and other related-party arrangements

Disclosures

- Example

The company participates in various construction joint venture partnerships. Generally, each construction joint venture is formed to accomplish a specific project and is dissolved upon completion of the project. The joint venture agreements typically provided...(details excluded). The Company's share of equity in these joint ventures ranges from 15% to 57%, the most significant of which includes...(details excluded). The combined assets, liabilities, and net assets of these joint ventures are as follows:



Disclosures

- Example (continued)

	December 31, 20xx	December 31, 20xx
Assets		
Total	\$ 165,361	\$ 260,275
Less other Venturer's %	116,988	188,803
Company's Interest	<u>48,373</u>	<u>71,472</u>
Liabilities		
Total	80,788	149,453
Less other Venturer's %	57,566	108,592
Company's Interest	<u>23,222</u>	<u>40,861</u>
Company's Interest in Net Assets	<u>\$ 25,151</u>	<u>\$ 30,611</u>

Disclosures

- Example (continued)

The revenue and costs of revenue of construction joint ventures are as follows:

	December 31, 20xx	December 31, 20xx
Revenue		
Total	\$ 463,634	\$ 646,277
Less other Venturer's %	328,612	469,350
Company's Interest	<u>135,022</u>	<u>176,927</u>
Cost of Revenue		
Total	413,512	575,432
Less other Venturer's %	294,304	418,628
Company's Interest	<u>119,208</u>	<u>156,804</u>
	<u>\$ 15,814</u>	<u>\$ 20,123</u>

Other

- Sales to the Joint Venture
 - General rule, intercompany profit resulting from sales of materials, supplies, or services to the joint venture by the venturer that controls the joint venture (either by majority voting interest or other means) is not recognized. Profit can be recognized if the following three conditions are met:

Other

- Sales to the Joint Venture (continued)
 - The transaction is entered into at a price determined on an arm's-length basis
 - There are no substantial uncertainties regarding the venturer's ability to perform
 - The venture is creditworthy and has independent financial substance

Other

- Differing Accounting Principles
 - The accounting principles adopted by the joint venture may be differ from GAAP
 - If the joint venture is not GAAP, the joint venture financial statements would first have to be adjusted to conform to GAAP before consolidation or use of equity method

Other

- Tax Considerations
 - Very important in the formation of the joint venture
 - Initial decisions about the legal form and types of contributions from the venturers can determine success or failure of the joint venture

Other

- Tax Considerations (continued)
 - Main areas of consideration:
 - ❖ Initial contributions
 - ❖ Joint venture earnings
 - ❖ Dissolution