

Pyramid

Third Quarter 2008

Practical ideas for construction and real estate organizations

Focusing on the business family

Baby boomers will have inherited \$40 trillion by 2052 (Source: *Foundation News and Commentary, 2006*) and some estimates are even higher. Read that statement again. Then, imagine far more at stake than mere squabbles among relatives and branches of ever-expanding families. The impact of this shift will be even greater for owners of a family business. Keeping the family healthy across generations in the face of substantial wealth and potentially less opportunity for direct involvement in the business, while supporting needs for organizational growth and adaptation in an increasingly complex and uncertain business climate, is a daunting prospect. In addition, family businesses will experience an unprecedented ownership and leadership shift in the next five to 10 years, creating significant implications for family leadership development and transition planning. Hold on for the ride of a lifetime.

Family business shareholders are challenged by the conflicting needs and sometimes irreconcilable priorities dictated by individual and family life transitions on the one hand, and the family business on the other. Managing the overlap between family and business is a critical factor for success and continuity. Families often wait until anxiety and ambiguity of a transition are overwhelming before making a change. By understanding the implications of this overlap, families can be proactive in their decisions rather than reactive to needs fomented by change.

A broader focus on family business

Historically, the focus has been on the alignment between family/ownership and business systems. But there is another distinction that needs to be made: that of owners of a business and members of a family.

“According to the Williams group’s research, family dysfunction causes financial and estate planning failure six times more often than any other factor,” (cited in *Groome, E.R., Challenges involved when emotional capital finds a voice*). Furthermore, lack of trust and poor communication were identified as the primary

factors contributing to failure in two-thirds of failed situations. The generally accepted belief is that the family is the main threat to long-term continuity of its business and wealth, not factors associated with the business system.

Relational issues are central to the “success” and “continuity” of family businesses. Consider some of the issues that impact the cohesion of many families: unresolved conflicts, sibling rivalry, poor communication, generational issues, difficult interpersonal relationships, family demands on the business and lack of trust.

Emotional capital and the business family

Family business consultants typically focus on helping family members define what they want for the family and the business. They then guide the process of aligning the family’s vision and values with its actions. Most family business consultants are involved in helping families create the structures that manage family governance factors in the context of the family business. Structural capital includes the structures by which a family governs itself in its business and investment dealings, wealth management, decision making, philanthropic efforts, and use of advisors. Development of a written family constitution is an example of the work a family might undertake to develop stronger structural capital.

However, the long-term success of a family business will depend on its investment in the concurrent growth of both the business and the family — in both its structural and its emotional capital. The degree of trust among family members is a critical factor for developing and maintaining business family emotional capital. In a broad sense, emotional capital includes the collective relational and emotional assets of members of an extended business family.

If a business grows and changes, and the family doesn’t, both the competitive advantage of the business and family “health” are at risk.

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FASB Statement 160: Could it put your bank loans and mortgages at risk?

For certain businesses, FASB Statement 160 will have a dramatic and potentially chilling effect. Known as *Noncontrolling Interests in Consolidated Financial Statements*, it has the potential to negatively impact a company's debt-to-equity as well as other ratios, which, in turn, could result in a company being unable to comply with certain financial covenants as required in their current loan documents. This means it could impact almost any enterprise, including many real estate companies and their related entities.

FASB Statement 160 is the first major amendment to Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, issued in August 1959. This new amendment affects the consolidated financial statements of for-profit companies and doesn't affect not-for-profit entities.

When Statement 160 goes into effect after Dec. 15, 2008 (calendar year 2009 for entities with a Dec. 31 year-end), companies with subsidiaries that aren't wholly owned may have to change how they present their consolidated financial statements for all entities in which the parent company has a controlling financial interest. Under the new rules, companies could be required to consolidate any investment they own regardless of ownership percentage — if they're considered to have "control." Furthermore, there could be instances where entities that had previously been consolidated would no longer be considered "controlled" and therefore would no longer be consolidated.

So, even if a company has only a 1 percent share in a subsidiary, it may be required to consolidate the subsidiary in its consolidated financial statement (e.g., a 1 percent general partner interest in a real estate limited partnership). If the parent owned in excess of 50 percent of the subsidiary, and had been consolidating it in the past, it may no longer be included in the consolidated group if the parent is deemed not to be the controlling owner.

“Under the new rules, companies could be required to consolidate any investment they own regardless of ownership percentage - if they're considered to have “control.””

This could be problematic if this new reporting changes a business' debt-to-equity ratio or the amount of earnings before interest, taxes, depreciation and amortization that an entity is required to have to satisfy certain requirements in loan agreements.

Unlike other similar changes that allow businesses to implement the change prior to the effective date, businesses can't submit a consolidated statement using the new Statement 160 before the business year ending after Dec. 15, 2009. If a 2009 statement is issued and contains information from an earlier year, that information will need to be presented in the new format also.

In the event that there is an issue, having extra time to plan provides a planning opportunity if addressed early on.

The changing role of due diligence in today's real estate market

It's a little more than a year since the first signs of a credit crunch hovered over the real estate market. The credit markets are at complete standstill since the second quarter of 2007, with no signs the market is reviving anytime soon. In a poll RSM McGladrey conducted at the Mortgage Bankers Association's Real Estate Finance/Multifamily Housing Convention & Expo 2008, more than 90 percent of the respondents stated their belief that the credit market will not recover until the third quarter of 2008 or later. Even in this tough environment, though, there are real estate investors successfully doing transactions — although at prices that reflect the current conditions.

Today is a very different market than the quick, easy and cheap money that buyers and sellers enjoyed in the not-so-distant past. Caution is the operative word when approaching real estate transactions today. The real estate segment hasn't bottomed out, hotels haven't quite topped out, and commercial/retail properties are the riskiest segment of all owing to the economy.

The biggest challenge facing the real estate market isn't recession or inflation, but an economy that moves sideways. Determining strategy during an economic downturn or during periods of economic growth is far less risky than determining strategy when the economic data teeters between inflationary pressures one month and recessionary risks the next.

Since real estate still provides one of the better returns on a risk-adjusted basis, one of the ways to mitigate your risk is by conducting extensive due

diligence. In fact, you may not have a choice. Lenders are requiring more due diligence and outside investors are insisting on it. In this current environment, you must demonstrate that you have more than satisfied your fiduciary obligations.

Every real estate transaction needs to focus on the economic performance of collateral, including revenues, expenses and the impact of timing on cash flows.

On the revenue side, it's important to look at:

- Lease agreements
- Credit quality of major tenants
- Quality of revenue growth
- Management companies' experience
- Historical trends of net rental revenue

Expense side due diligence should include two key questions:

- How fixed are the fixed expenses?
- How controlled are controllable expenses?

Discounted cash flow analysis should consider:

- Historical trends of revenues and expenses
- Timing of projected increases in revenues and savings in expenses
- Timing of planned capital expenditures

Your outside advisors should have a thorough understanding of the real estate market to properly assess the risk on your behalf.

Business family, continued from page 1

Businesses usually change and grow based on an intentional plan. Too often, expectations and assumptions are that the family will change and grow on its own without the guidance of intention, a plan or choice. But that's not necessarily the case. Families resist change, focusing on safety rather than growth.

Differentiating our family business and business family

At the cusp of a major transition in family business continuity: A change in not only the leadership of family business entities but also the transfer of considerable wealth.

When the family and business grow, owners of a family business often fail to take proactive steps related to investing in the family. Evidence suggests that planning for these changes is sorely lacking. Developing structures and guiding a process of individual and family development will not only increase the emotional capital within the family, but also will strengthen its ties to the business — ultimately its success and continuity.

If your family isn't already, now is the time to focus on balancing needs related to ownership of a family business and membership in a business family — you can't afford not to.

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5000 Mcknight Road, Suite 404
Pittsburgh, PA 15237

2599 Wilmington Road
New Castle, PA 16105

381 Chestnut Street
Meadville, PA 16335

Address Service Requested

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If you have any questions or concerns, please call Eric Wallace, CPA, at 412-635-6270, or James Pitzer, CPA at 724-658-1565.

Offices throughout western Pennsylvania and eastern Ohio

Website: www.carbis.com

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