Construction Accounting & Taxation

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Construction Accounting Methods for Financial Reporting and Income Tax Reporting

Should They Ever Be the Same?

By Barry A. Fischman and Joseph Natarelli | Wednesday, July 17, 2019

Construction contractors operate in a distinctive environment due to the unique nature of their business. Many contractors may wonder how their financial statements may show net income in an amount that differs from that shown as taxable income on their tax returns. Simply stated, the Internal Revenue Service allows for different methods of accounting for construction contracts for income tax reporting purposes, as opposed to financial statements that are usually required to be based on Accounting Principles Generally Accepted in the United States of America (GAAP). This article reviews several scenarios highlighting the accounting treatments available to construction contractors that may differentiate their financial reporting from their income tax reporting.

AN OVERVIEW OF GAAP

Financial statements prepared in accordance with GAAP are typically a requirement of banks and sureties. The financial statement of a contractor should be based on the percentage of completion method of accounting for all long-term contracts, and disclosures should include:

- detailed notes to the financial statements;
- contracts receivable aging;
- a breakout of contracts and retention receivables by contracts in progress, jobs completed and unbilled receivables;
- an earnings from contracts schedule that reconciles the contracts in progress and contracts completed during the year to the statement of income;
- a contract in progress schedule and completed contracts schedule that illustrate the contract revenues, costs and gross profits by project for the accounting period;
- explanation of significant contract gross profit changes;
- collections on accounts receivable subsequent to the reporting period (not required by GAAP but a best practice);
- disclosure of retention accounts payable; and
- contract backlog disclosure.

An excellent example of a sample contractor financial statement can be found in the AICPA Audit and Accounting Guide for Construction Contractors.

Topic 606, Revenue from Contracts with Customers

Effective Jan. 1, 2018, for public companies and Jan. 1, 2019, for private companies, contractors are required to adopt Accounting Standards Codification 606, Revenue from Contracts with Customers (Topic 606). Based on recent public construction company 10-Q filings for public companies that have gone through the adoption process, Topic 606 has had material impacts on the financial statements of construction companies. Topic 606 requires the recognition of revenue to coincide with the transfer of goods and services to customers, which for construction contractors will continue to follow the recognition of revenue over time, consistent with cost-to-cost percentage of completion.

While it is true that the adjustment to the financial statements of construction companies is not always material, there must be an analysis performed by management of construction companies to support this conclusion.

Topic 842, New Lease Standard

The new accounting standard on accounting for leases, Accounting Standards Update 2016-02 (Topic 842) is bringing changes in the way operating leases are recorded. In the past, operating leases only appeared as an expense in the financial statements, with future obligations for operating leases not appearing on the company's balance sheet. Topic 842 requires that these off-balance liabilities are required to be recorded, presenting an asset related to the right-to-use the leased item, and a liability for the value and obligations created by the full terms of the leases.

While the impact of Topic 606 will result in a net zero change to the reported gross profit and net income of the contractor, recording the right of use asset and liability on leases will have an impact on the contractor's debt covenants. Additionally, contractors will be managing the effects of Topic 842 by potentially restructuring the leasing of equipment for projects.

Cost to Complete

Contractor financial statements rely heavily on estimates. One thing that is critical to the contractor is the Estimated Cost to Complete on Contracts in Progress (ECCCP). Without accurately determining the ECCCP, a contractor's financials can fluctuate wildly from one month to the next. Changing these estimates can have a significant impact on the financial statements, so contractors should take this task very seriously.

Depreciation

Another estimate that is important for contractors that have equipment-intensive businesses, such as heavy highway contractors, is depreciation. If the equipment's useful life is not correct, the contractor could be charging an excessive amount of expense to a project, which would have a negative impact on profitability. More often than not, contractors are incorrectly using the same depreciable lives and methods for financial statement and income tax reporting. In doing so, a contractor may be significantly understating equity by using an accelerated tax method for financial statement reporting. This can have a significant impact on a bonding and banking program.

TAX SCENARIOS SPECIFIC TO CONSTRUCTION ACCOUNTING

Understanding IRC 460

Enacted by the Tax Reform Act of 1986, Internal Revenue Code section 460 (IRC 460), Special Rules for Long-Term Contracts, exists as one of the only code sections that is aimed almost exclusively at a specific industry: construction. For those engaged in the construction industry, it is critical to understand the complexities of IRC 460 and properly apply its provisions. Different contractors have different circumstances. When following the provisions of IRC 460, different circumstances yield different results.

There are many income tax methods of accounting available to contractors. The first overall concept is that if a construction contract is long term, contractors are required to use the percentage-of-completion method (PCM) for income tax reporting tax purposes. While this is a requirement, exemptions do exist for a home construction contract or if the taxpayer meets the small contractor exception.

A home construction contract is any contract in which 80% or more of the estimated total contract costs are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of dwelling units contained in buildings containing four or fewer dwelling units. In this case, that contract is not required to use PCM and another tax accounting method may be used. The subcontractor may look through the contract to see the work required by the general contractor and thus may have a home construction contract.

The following two requirements need to be met for the small contractor exception to apply:

- At the time the contract was entered in to, it was estimated that the contract would be completed within a two-year period beginning on the commencement date of the contract; and
- The contractor's average annual gross receipts for the three taxable years preceding the year in which the contract was entered does not exceed $25 million.

Average annual gross receipts are measured on the revenue reported for income tax purposes. Therefore, it is necessary to apply proper tax reporting to exempt and non-exempt IRC 460 contracts so as not to inadvertently overstate your gross receipts. The three years is looked at on a current and going forward basis. In a year that the small contract exemption is not met, only contracts that start in subsequent years are required to be reported on PCM. Existing contracts will remain exempt from IRC 460 and the taxpayer continues to use the elected method of accounting for income tax purposes until the job is complete. Conversely, a large contractor who eventually meets the small contractor exemption may begin using whatever exempt methods they have previously elected on their new exempt contracts.

There are yet other income tax reporting opportunities for large contractors and, probably for that reason, CPAs who work with construction clients often spend a lot of time trying to maintain small contractor status to avoid reporting under PCM. There are a variety of deferral options available to the large contractor under IRC 460 including:

- 10% elective deferral;
- Residential contracts;
- Retainage receivable and payable; and
- Methodologies to allocate general and administrative expenses in accordance with IRC 460.

Another major concept often overlooked is that applicable methods of tax accounting are determined on a contract-by-contract basis. Therefore a contractor could be reporting revenue from construction contracts under several methods of accounting, each of which can produce different results.

Discussed below are some income tax methods available to contractors.

Cash Basis
The cash basis method is very enticing for contractors (if they are able to qualify). This method calculates income based on the inflow and outflow of cash. Under this method, accounts receivable, retainage, work in progress and prepaid assets are not considered to be a part of income for tax purposes until realized (collected or paid). Since this method results in deferrals, it is not uncommon for a contractor to show a significant income for financial statement purposes while possibly showing a loss for income tax reporting purposes.

To qualify for the cash basis method, contractors cannot have significant inventories or be required to maintain inventory, and they cannot average more than $25 million (Note: $5 million for C-corporations requirement has been eliminated by The Tax Cuts and Jobs Act.) in gross receipts for the prior three years (as measured on the income tax return), and the use of the cash method cannot significantly distort income. Qualifying for the cash method in almost all situations will result in lower taxes than any other income tax methods.

It is important to know the type of work the contractor is performing, as sometimes contractors report on the PCM for income tax purposes when IRC 460 is not applicable (construction managers not at risk) and perhaps the cash method of accounting for income tax purposes may yield a better result.

Accrual Method
This income tax method of accounting reports income from construction contracts as progress

billings are made and deducts expenses as job costs are incurred. Using the accrual method of accounting may result in a situation where the contractor is able to show significant income for financial statement purposes while minimizing taxable income. Taxable income will increase when a contractor is overbilled on a job, and taxable income will decrease when a contractor is under-billed on a job.

Accrual Less Retainage
Retainage is defined as when a percentage of billings for services performed are withheld by the customer until completion. A contractor can establish a method of accounting to defer retainage receivables from accrual basis income until the contractor receives a green light on completion and acceptance from the customer. This method could create a significant income deferral for small contractors exempt from IRC 460 when selected as an income tax method of accounting. Large contractors who elect this method may benefit from their short-term contracts if retainage receivables and retainage payables are outstanding at year-end. If a contractor is not currently deferring retainage and wants to elect this provision, look to the provisions under Revenue Ruling 69-314 (a change in method of accounting requiring a Form 3115 filing). The requested change is now an automatic change.

Completed Contract Method (CCM)
CCM is one of the most commonly used methods for exempt contracts because all contract revenue and related contract costs are deferred until the job is finished. A contract is considered complete when at least 95% of contract costs have been incurred and the customer has use of the property. The contractor then must report the remaining total contract revenue in the year the contract is deemed (for IRS purposes) to be complete and account for all remaining costs in subsequent years under its overall method of accounting.

Additionally, CCM is not a permissible method for alternative minimum tax (AMT) and is thus a tax preference item. Take note of how this AMT preference under CCM will impact the contractor’s tax liability.

Cost Allocation
As required under IRC 460, a contractor needs to allocate additional costs—general, administrative and overhead (G&A)—to contracts when costs are already allocated for financial statement purposes. In general, all costs that directly benefit or are incurred by reason of the performance of the long-term contract must be allocated to each long-term contract.

You might think that allocating additional G&A costs to a contract in progress will accelerate the percent complete and therefore cause additional revenue to be recognized and thus increase taxable income (at least this is what the IRS believes). However if you understand the formula for the calculation of PCM for income tax purposes in a general sense, you will see that when you allocate current G&A cost incurred to date you also have to estimate the future G&A costs to be incurred on that contract job in progress. In all likelihood, your percentage complete will be different as will the revenue recognized to date.

Establishing a methodology to estimate the future G&A costs to be incurred thus complying with the requirements of IRC sec 460, will result in a different gross profit on contracts for income tax purposes.

10% Elective Deferral
Under IRC 460, a contractor may defer recognition of gross profit until the job is at least 10% complete. This is a one-time election and applies to all long-term contracts entered into during and after the electing year. In addition, this income tax deferral is not an AMT preference item.

RESIDENTIAL CONSTRUCTION CONTRACTS FOR MULTIFAMILY

A contract that qualifies as a residential contract allows a taxpayer to report 70% of the contract on PCM and 30% of the contract using the large contractors' exempt method of accounting for income tax purposes. If the contractors' exempt method is CCM, then 30% of the job profit is deferred for income tax reporting purposes until that job is complete.

Take note of how this deferral is an AMT preference and will impact the contractor's tax liability. The definition of a residential construction contract is similar in definition to a home construction contract, except that "dwelling unit" is more broadly defined as a house or apartment used to provide living accommodations in a building or structure. Examples of residential contracts include apartment buildings, nursing homes, assisted living facilities, prisons, dormitories, barracks and mixed use developments.

TAX CUTS AND JOBS ACT

The Tax Cuts and Jobs Act (TCJA) which was passed into law on Dec. 22, 2017, introduced several changes and simplification to tax accounting methods available to contractors. The $10 million average annual gross receipts threshold was increased to $25 million and is now indexed for inflation.

Reporting on the cash basis of accounting for income taxes may now be available for contractors that are C Corporations, Partnerships with C Corporation Partners as well as other entity structures, S Corporations, Limited Liability Company or Sole Proprietorships, where the three year average of gross receipts is below the threshold.

Contractors with inventories may also be allowed to use the cash method of accounting where average gross receipts is below the threshold. Inventories can be treated as non-incidental costs or treated in conformity with the taxpayer's financial accounting method.

The exemption from the requirement to report contracts for income tax purposes on the percentage completion method under Internal Revenue Code 460 has also been increased to the new $25 million level.

The TCJA contains a new provision regarding the timing of income recognition for income tax purposes. The new provision requires an accrual basis taxpayer to recognize income no later than the tax year of inclusion on certain GAAP or IFRS applicable financial statement (or any other financial statement designated by Treasury).

There is an exception for long-term contracts to which Internal Revenue Code 460 applies. Under this new provision, the “all events” test is deemed satisfied when the income is recognized on the financial statement for tax years beginning after Dec. 31, 2017. An applicable financial statement includes an audited financial statement. As such, pursuant to this income conformity rule, a contractor with an audited financial statement may no longer avail themselves of the accrual less retainage method of accounting for its short-term contracts. The alternative minimum tax (AMT) has been eliminated for C Corporations after 2017.

BEST PRACTICES

To properly advise the contractor, CPAs must not only know and understand GAAP, as well as the income tax rules and provisions under IRC 460, but also must be able to identify the contracts that lend themselves to deferral opportunities.

The work in process (WIP) schedules for open and closed jobs is a great place to start. The WIP should be reviewed for the type of work being performed and the percent complete. Look through the contract to understand the intended use of the project for which the work is being performed. Once the CPA understands the WIP and has a thorough knowledge of the contract, only then is he or she in a position to identify available tax deferrals.

The best way to make sure all the relevant applications of IRC 460 are being considered for a contractor is to use a tax checklist. An engagement team that understands the differences between GAAP and IRC 460 for construction contracts will best meet the varied financial and income tax reporting needs of the contractor.

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