Construction Contractors: Accounting and Financial Reporting Issues

CST4/26/V1

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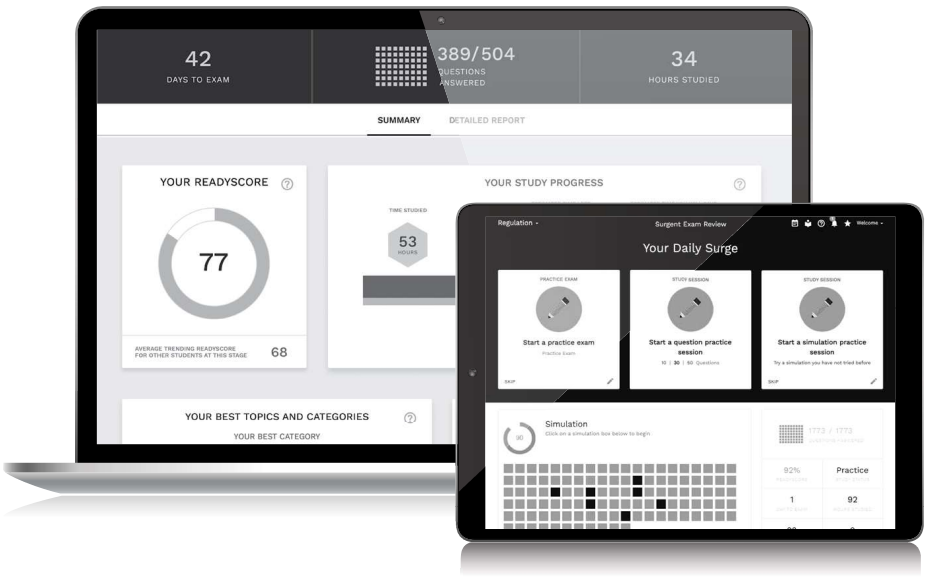

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Revised May 2026

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The Construction Industry – An Overview

Learning objectives

Upon reviewing this material, the reader will be able to:

- Recognize the impact the construction industry has on the U.S. economy; and
- Identify the different segments of the construction industry

I. Introduction

The construction industry is considered by many to be the barometer for the United States economy. When there is abundant construction work available, it is usually an indication of a strong economy. Conversely, when this sector of the economy is weak, it is usually an indication of an economic slowdown.

As recorded by numerous United States Census Bureau reports issued over the past number of decades, the construction industry consistently has been:

- The largest private employer in the U.S. economy;
- The largest contributor to the U.S. economy; and
- The largest consumer of any industry in the U.S. economy.

The power and influence of the construction industry cannot be ignored. A man once said, “When the construction industry comes down with a cold, the entire United States economy catches the flu.”

While there are many types of construction engagements, real estate and construction projects are perhaps the two most important in the accounting and tax world. The terms sound similar. However, from an accounting and tax perspective, the distinction is important.

As a general rule, if an entity is building on land that it owns for its own use, the project is considered a real estate project and is accounted for under the requirements under FASB ASC 970, *Real Estate – General*; FASB ASC 360, *Property, Plant, and Equipment*; and FASB ASC 835, *Interest*. On the other hand, if the entity is building on property owned by someone else for someone else’s use, the project is considered a construction project and is accounted for under the requirements under FASB ASC 606, *Revenue from Contracts with Customers*.

II. The construction industry

There are many players in the construction industry. It is important for accounting and tax professionals to know the main actors and how they interact with each other.

A. The owner

The owner is the party that initiates the construction project, provides financing for the project, and retains legal title during the duration of the project. It could be an individual, partnership, corporation, not-for-profit entity, or a government agency.

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B. The surety

The surety is a guarantor. They guarantee completion of the project in accordance with the specific terms of the contract. Without a strong surety market, the construction industry cannot properly operate.

C. The bond agent

The bond agent is the matchmaker whose primary responsibility is to match a contractor with the appropriate surety. They will also analyze a contractor's financial statements before they are made available to the surety in order to provide their opinion on whether a contractor should or should not be provided with bond credit.

D. The bank

Whereas the surety provides credit related to direct job performance, the bank is also a critical component of the construction industry. The bank provides the contractor with credit in order to finance its non-construction-related operations.

E. Design professionals

Design professionals are hired by the owner to be their eyes and ears at the jobsite. They usually consist of architects or engineers. As a general rule, architects are usually associated with buildings while engineers are usually associated with road and other types of construction.

F. The attorney

A well-qualified attorney is an integral part of the construction industry. In order to be effective, this person should possess specific expertise in the following three areas:

- Surety law;
- Employee/employer relationships; and
- Construction contract issues.

A contractor who does not engage legal counsel with these particular areas of expertise is setting themselves up for potential problems, whether from its employees, the owner, the surety, the bank, or its subcontractors.

G. The CPA

Similar to the attorney, the contractor should engage a CPA who possesses expertise in the following areas:

- U.S. GAAP both in general, and in particular, the construction industry;
- Financial statement preparation in the format required by the surety, bank, and other users of the financial statements;
- Tax preparation, both in general and for the construction industry; and
- Excellent written, verbal, and negotiation skills.

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H. The contractor

Lastly, there is the contractor. There are generally five types of contractors related to the construction industry:

a. **The general contractor (also known as the prime contractor)** – The general contractor is the party who assumes full responsibility for completion of the job in accordance with the terms of the contract. They are the party who typically enters into the contract with the owner. Some general contractors will self-perform all of the work themselves, while others will engage subcontractors to perform all or part of the work.

b. **The subcontractor** – A second-tier contractor who enters into a contract with the general contractor in order to perform all or part of a project.

c. **The construction manager** – An entity who enters into a contract with the owner to manage and supervise the various construction work of a particular project. Their responsibility is not to actually perform the construction work, but to negotiate contracts with others in order to complete the project.

d. **Heavy construction** – A particular type of contractor associated with major projects, including:
   (i) Roads;
   (ii) Dams;
   (iii) Large buildings; and
   (Iv) Bridges.

e. **Design build** – Specializes in particular heavy construction work such as hydroelectric and power plants. This type of contractor requires extensive management skills. They typically manage all phases of the project.

III. Construction contracts

In addition to having an extensive knowledge of the various construction **contractors**, it is necessary to have a thorough knowledge of the various types of construction **contracts**.

A. Fixed-price contract

Under this type of contract, the contractor warrants that they will complete the contract at an agreed-upon price. The contractor is responsible for any unforeseen circumstances, including:

- Oversights or omissions in the original bid;
- Labor shortages;
- Material shortages; and
- Delays caused by weather.

For example, if Eskin Construction contracts with the Philadelphia Sports Authority to build a new stadium in the amount of $100,000,000, then Eskin would be responsible for any overages (with the possible exception of errors encountered in the plans and specifications) that they incur in completing the terms of the contract.

By the very nature of this kind of contract, it is generally the safest for the owner (since their costs are capped by the contract amount) and riskiest for the contractor (since they usually have full responsibility for any unanticipated costs incurred). A fixed-price contract is also known as a lump-sum contract.

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B. Unit-price contract

A unit-price contract is similar to a fixed-price type of contract, but it varies if the number of units required differs from the engineer's report. Under this type of contract, the contractor is paid a specified amount for every unit of work performed. It is usually associated with road work contracts.

C. Cost-plus contract

Under a cost-plus type of contract, the owner agrees to pay the contractor a fixed fee in addition to the actual costs incurred by the contractor. This fee may be:

- Fixed; or
- Calculated as a percentage of costs incurred.

D. Time and material contract

Under this type of contract, the contractor is paid by the owner on the basis of direct labor hours incurred at fixed hourly rates plus the cost of materials incurred by the contractor. This type of contract is generally considered the safest for the contractor since all of their costs incurred are covered, but it is the riskiest for the owner since they are responsible for all costs incurred by the contractor.

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U.S. GAAP and the Construction Industry

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U.S. GAAP and the Construction Industry

Learning objectives

Upon reviewing this material, the reader will be able to:

- Identify the sources of U.S. GAAP for the construction industry;
- Recognize how U.S. GAAP applies to the construction industry from both a theoretical and a practical perspective;
- Recall how ASC 606 has impacted the construction industry; and
- Recall how ASC 842 has impacted the construction industry.

I. Introduction

In this chapter, we will discuss U.S. GAAP and the construction industry. The approach that will be taken is to not only present the theory behind the many U.S. GAAP issues, but also to demonstrate the practical application of what is required of the construction industry.

Many CPAs believe accounting and financial reporting for the construction industry is more complex than other industries. This perception may be due to the following factors:

- ASC 606 and its unique impact on the construction industry.
- Many construction projects take a relatively long time to complete. The longer the construction period, the greater the potential risk of a U.S. GAAP error.
- Proper accounting for change orders and claims can be difficult (to be discussed in Chapter 4).
- The contractor often has more users of its financial statements than virtually any other line of business, including:
  - (i) The surety;
  - (ii) The bank;
  - (iii) Other asset-based lenders (for example, equipment financing companies); and
  - (iv) Public owners (for example, if a state agency requires financial statements in order to prequalify a contractor to allow them to bid on jobs).
- The issue of cash flow for both each individual contract and the contractor as a whole.
- The impact of retention on the contractor's cash flow and profitability. Retention is a clause in the contract that allows the owner to withhold a percentage (usually 10 percent) of the progress payments due to the contractor until the job is completed. The purpose of retention is to provide the owner a level of security for:
  - (i) Costs incurred for any defective work performed by the contractor;
  - (ii) To settle claims from parties not paid by the contractor; and
  - (iii) To ensure that work was performed in accordance with the terms of the contract.
- Proper accounting of subcontractors can be difficult (to be discussed in Chapter 3).
- Proper and appropriate financial statement preparation and presentation (to be discussed in Chapter 3).
- The impact of ASC 842 on the construction industry.

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II. Sources of U.S. GAAP for the construction industry

The general guidance for applying U.S. GAAP for the construction industry is FASB ASC 606, *Revenue from Contracts with Customers*. Changes resulting from this FASB will be discussed both in this chapter and subsequent chapters. In addition, guidance is available from the AICPA Audit and Accounting Guides, *Construction Contractors* and *Construction Contractor Audit Risk Alerts*. It should also be noted that in 2016, the FASB issued ASC 842, *Leases*, resulting in a significant impact on both the contractor's balance sheet and income statement.

III. Accounting for construction contracts

In order for the contractor to properly account for a contract according to U.S. GAAP, three steps must be considered:

1. Determining the profit center;
2. Determining the method of accounting to apply to that contract; and
3. Actually applying the method chosen.

A. Determining the profit center

When a contractor accounts for its various contracts (in order to prepare its financial statements), U.S. GAAP mentions three methods available to the contractor:

- **Examining each individual contract** – Each contract would be reflected individually in the contractor's books and records, and ultimately on its work-in-progress schedule sent to the surety along with the rest of the financial statements;
- **Combining contracts** – The contractor may combine similar contracts into a single number on the work-in-progress schedule; and
- **Segmenting contracts** – The contractor may decide to break out (segment) an individual contract into numerous contracts for reporting purposes on the work-in-progress schedule.

This is all in theory per U.S. GAAP. However, more practically, if a contractor is seeking to obtain bond credit from the surety, there is only one method that should be utilized – examining each individual contract. In order to assist the surety when it is analyzing a contractor's financial statements (in particular, its work-in-progress schedule), the various financial information should be presented by the contractor as clearly and as understandably as possible. Issues such as combining and segmenting contracts may confuse the underwriter and could result in the surety denying bond credit based on that factor alone. Therefore, in most instances, the contractor should report each individual contract on its work-in-progress schedule. Revenue is then generally recognized based on costs incurred as a percentage of the total contract price.

B. Proper U.S. GAAP treatment for determining the estimated total contract price

In order to determine the amount of revenue to recognize and its related gross profit while a job is still in progress as of the balance sheet date, the contractor must first determine the estimated total contract price.

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The total contract price is determined by utilizing the following steps:

1. The contractor begins with the original contract price per the contract signed by all applicable parties. (It should be noted that any unsigned contract is NOT considered reliable and appropriate evidence.)
2. The amount per the contract is adjusted for approved change orders (discussed in more detail in Chapter 4). The change order can either increase or decrease the amount of the original contract.
3. This amount is reduced for various items such as:
   (i) Liquidated damages (defined as daily incurred penalties assessed by the owner per the terms of the contract if the contractor is behind schedule as detailed in the contract);
   (ii) Actual damages to the owner the contractor may cause; and
   (iii) Back charges represent billings for work performed or costs incurred by one party that should have been performed by another party. Since the initial contractor did not perform as required, the other party can then back charge those amounts incurred to the initial contractor.

   These three items will reduce the contract amount if their assessment is considered probable and the amount can be measured. When discussing these contract reductions, the contractor must consider both those already assessed as of the reporting date in addition to those anticipated to be assessed.
4. Other considerations per the type of contract – Depending on the type of contract the contractor is working under, there may be additional adjustments to the original contract price. These include:
   (i) Fixed-price and unit-price contracts:
      - Incentives and penalties.

   (ii) Cost-plus contract:
      - Different interpretations (between the owner and the contractor) on the definition of a reimbursable cost.
      - If not stated in the contract, possible adjustments may be made due to the maximum total of reimbursed costs.
      - Different interpretations (if not clearly stated in the contract) on the definition of which particular costs and fees may be reimbursed from the owner to the contractor.

   (iii) Time and materials contract:
      - If not clearly stated in the contract, there may be different interpretations on the amount of markups and if there are in fact any guaranteed maximums to labor and material costs.

The four items noted above are all netted together in order to derive the total contract price.

C. Proper U.S. GAAP treatment of the costs and expenses

In addition to the total contract price side of the equation (as we have just been discussing), the percentage-of-completion method also considers COSTS. Therefore, now would be the appropriate time to discuss how U.S. GAAP considers various costs and expenses incurred by the contractor when working to complete their projects.

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The following costs are typically incurred by a contractor related to their construction work:

- Precontract costs;
- Direct job costs;
- Indirect job costs;
- Estimated costs to complete;
- Equipment costs; and
- General and administrative expenses.

1. Precontract costs

Precontract costs are costs incurred by the contractor prior to the signing of the contract.

Examples of precontract costs include:

- Travel (for an out-of-the-area job);
- Professional fees (legal and accounting);
- Engineering; and
- Estimating and bidding expenses.

The question raised under U.S. GAAP is whether these costs should be currently expensed as a general and distractive expense or capitalized as a job cost.

As we have previously detailed, beginning in 2021, FASB ASC 606 became effective for all entities. A provision of this ASC deals with incremental costs incurred to obtain a contract (defined as those costs that would have been avoided if the contractor did not seek to obtain the contract). The ASC instructs that these costs should be capitalized as part of the cost of the contract. However, it should be noted that there is an election to expense these costs in the period they are incurred if the amortization period is determined to be one year or less.

2. Direct job costs

Direct job costs are those costs directly related to the performance of an individual job. Examples of direct job costs include the following:

- **Direct labor** – Includes not only the payroll cost of the construction employees, supervisors, and project managers, but also includes related costs such as payroll taxes, employee benefits, retirement plans, etc.
- **Direct materials** – Materials that are used to construct a project. If the contractor purchased materials that ultimately were not used on the job and were subsequently sent to the contractor's warehouse, they should not be included as a job cost, but should be considered the contractor's inventory.
- **Subcontracting costs** – Amounts billed by the subcontractors working directly on the particular job, less retention held back by the contractor, are considered direct job costs.
- **Equipment costs** – Costs related to equipment used for a particular contract. Included under this category is both owned and leased equipment.
  - (i) Costs associated with leased equipment include the rental charge, insurance, oil and gasoline, and maintenance.
  - (ii) Costs associated with owned equipment include interest on the related debt, oil and gasoline, maintenance, and depreciation.

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- **Other costs** – Other direct costs incurred by the contractor not included in the above-categories may include:
  (i) Travel and other related costs such as meals and lodging incurred by the construction crew for jobs located out-of-town;
  (ii) The cost of surety bonds;
  (iii) Jobsite utilities; and
  (iv) A portion of precontract costs (as previously discussed).

All direct job costs should be capitalized and charged to the job they apply to.

3. Indirect job costs

While contractors may use terms such as job overhead or general conditions, in the CPA vocabulary, these are usually referred to as indirect job costs.

By definition, indirect job costs represent job costs incurred by the contractor that are not directly related to a particular project. Examples of indirect job costs include:

- Quality control and inspection;
- The contractor's general liability insurance;
- General construction tools and supplies;
- Payroll, payroll taxes, and employee benefits of contractor employees who work on numerous projects (for example, a project manager);
- If the contractor does not include payroll taxes and employee benefits as part of direct labor, then these components should be categorized as indirect job costs to be allocated to the contractor's various contracts;
- The cost of common usage facilities (for example, a storage warehouse) that benefits numerous projects. Included under this category are rental costs (if the facility is leased), interest and depreciation (if the facility is owned), utilities, and maintenance; and
- The cost of equipment used on numerous contracts. Included under this category is both owned and leased equipment (discussed later in this chapter).
  (i) Costs associated with leased equipment include the rental charge, insurance, and oil and gasoline, and probably maintenance.
  (ii) Costs associated with owned equipment include interest on the related debt, oil and gasoline, maintenance, and depreciation.

The next issue involving indirect job costs is how they should be allocated to the individual contracts. U.S. GAAP provides the contractor with much latitude on what method can be used. Some of the acceptable methods include those based on:

- Direct labor hours;
- Direct labor costs; and
- A combination of both direct labor and direct materials.

However, U.S. GAAP instructs the contractor that the method chosen must be:

- Systematic;
- Rational; and
- Consistent from year to year.

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One of the more widely used methods utilized by contractors is to allocate their indirect job costs through the use of burden rates. Under this approach, the contractor computes a burden rate by dividing total overhead by the total of the allocation base selected (for example, total direct material costs or direct labor costs). The computed burden rate is then applied to the allocation base for each contract in order to arrive at the amount of indirect job costs that should be allocated to that particular contract.

Example: Eskin Construction has $60,000 of indirect job costs to allocate. Eskin has determined that using direct labor costs is the method that is most systematic, rational, and consistent from prior years. The allocation is based on direct labor costs of $200,000. Therefore, the burden rate utilized to allocate the indirect job costs would be $60,000 ÷ $200,000, or 30 percent.

	Direct Labor	× Burden Rate	= Allocated Overhead
Contract 101	$70,000	30%	$21,000
Contract 102	20,000	30%	6,000
Contract 103	30,000	30%	9,000
Contract 104	80,000	30%	24,000
	$200,000		$60,000

An important concept that some contractors fail to comply with in accordance with U.S. GAAP when allocating these costs is that the indirect job cost allocation must be made to all jobs worked on by the contractor during the year – both those in progress as of the balance sheet date and those completed during the year. The difference between jobs in progress and jobs completed during the year is that all costs charged to those jobs in progress are allocated between the balance sheet and the income statement, while those costs charged to jobs completed during the year flow directly to the income statement. As a result of this problem, a contractor's recognized gross profit on their construction jobs, bottom-line net income, and assets could all be significantly overstated if indirect costs are not allocated to jobs completed during the year. The surety industry (in addition to the banking industry) has historically incurred significant losses because they relied upon financial statements where indirect job costs were charged exclusively to jobs in progress as of the balance sheet date and not allocated (or under-allocated) to jobs completed during the year resulting in over-reporting of both gross profit and net income.

4. Equipment cost allocation

Equipment costs are a specialized area of indirect job costs requiring additional consideration. Whether the contractor's equipment is owned or leased, a method of allocating equipment used on various jobs must be established to properly allocate those costs.

There are a number of methods contractors can utilize to allocate these costs. They include:

- Charging all equipment costs incurred to overhead (indirect job costs) and then allocating those costs together with the contractor's other overhead costs;
- Charging all equipment costs to an equipment cost pool and then allocating those costs to the various jobs;
- Allocating depreciation expense (for owned equipment) directly to the job and charging other equipment costs (rental, repairs, fuel, etc.) to an overhead account; and
- Charging the costs of the equipment used on a job to that particular job and charging costs that cannot be specifically identified to overhead.

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5. Estimated costs to complete

On every contract a contractor works on that extends beyond the balance sheet date, they will need to estimate how much it will cost to complete the work associated with the contract from the balance sheet date through completion.

Many CPAs consider this the most important part of the construction process as far as financial reporting is concerned. This is due to the fact that this number is little more than a guess developed by management.

However, for now, it should be noted that previous U.S. GAAP (FASB ASC 605-35) provided the contractor with the following five guidelines on how to derive this estimate:

- There should be systematic procedures that are consistent with the cost accounting system which should be used to provide a basis for comparing actual and estimated costs.
- In estimating total contract costs, the quantities and prices of all contract cost should be identified.
- The accounting process should provide that estimated costs to complete should include the same elements of cost that are included in actual accumulated costs. Also, those estimated costs should include expected price increases.
- The effects of future wage and price escalations should be taken into account in cost estimates, especially when the contract performance will be carried out over a significant period of time. Escalation provisions should not be blanket overall provisions, but should cover labor, materials, and indirect costs based on percentages or amounts that take into account consideration experience and other pertinent data.
- Estimates of costs to complete should be reviewed periodically as appropriate to reflect new information.

6. General and administrative expenses

A contractor's general and administrative expenses should be currently charged to an expense (NOT capitalized as job costs) as incurred since they do not directly or indirectly benefit the job.

D. Accounting for loss contracts

Everything we have been discussing to now assumes that the project will show a profit when it is completed. However, if after comparing the estimated total contract revenue to the costs incurred to date plus the estimated costs to complete the job, a loss is anticipated, the full (not percentage-of-completion) loss should be recognized on the contractor's books and records. This treatment is consistent with U.S. GAAP's theory of conservatism, especially in the area of revenue recognition. The journal entry would be to debit a provision for losses on contracts (an income statement account) and credit an accrued liability account.

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E. Subcontractors

When a contractor is acting as a general (prime) type of contractor, in many instances, they will hire subcontractors to perform portions of their contract responsibilities. There are numerous reasons why the general contractor would do this:

- Since the subcontractor may have expertise in a specific construction area (plumbing, electrical, HVAC, etc.), it could make the general contractor's job performance more effective and efficient;
- It provides the general contractor with an effective way to spread the risk among other parties; and
- It also provides the general contractor with an effective way to ease any financing difficulties they may face on the job.

However, even though the subcontractor warrants to complete their contract responsibilities, the general contractor is still responsible to the owner for the project regarding the work performed by the subcontractor and would be required to pay the subcontractor's labor and material obligations. For this reason, it is highly recommended that the general contractor exercise a degree of control over their subcontractors. Many contractors (along with their outside CPA) mistakenly believe that when they sign a contract with a subcontractor, they are relieved of any responsibility to the owner for that portion of the contract.

Therefore, a contractor should (whenever feasible):

- Closely monitor the work performed by the subcontractor;
- Closely monitor the financial condition of the subcontractor;
- Try to only contract with those subcontractors who are bonded by a surety; and
- Include a retention clause in their subcontractor agreement whereby they can hold back 10 percent of billed amounts. There are two reasons for this:
  - (i) To improve the contractor's cash flow since in most instances, the owner is retaining 10 percent of the amounts billed by the contractor; and
  - (ii) As an assurance to the contractor for any problems associated with the quality of the work performed by the subcontractor.

F. Long-term asset impairment

In today's economy, there are occasions when facts and circumstances change which then raise doubts about a contractor's ability to fully recover the carrying amount of a particular asset. When this is the case, that asset is considered impaired in accordance with U.S. GAAP (FASB ASC 360-10-20, *Property, Plant, and Equipment*). The FASB provides the guidance on both the recognition and measurement of impairment losses. The FASB also provides specific examples of conditions or changes in conditions which may be indications of possible impairment.

Even though a contractor is required to consider possible impairment for every asset on their balance sheet, for the construction industry, the asset most subject to impairment consideration is property and equipment. The issue of a possible impairment of a contractor's equipment is especially an issue when there is a downturn in the construction industry as a whole (or a particular segment of the industry). For example, a road builder may have acquired an extensive amount of equipment to perform their various construction obligations. However, when there is a downturn in this segment of the economy, not only will the contractor have little use for the equipment, but there may also be few buyers available to purchase the excess equipment.

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One of the requirements under FASB ASC 360 is that the contractor must determine whether the asset is either:

- Held for use; or
- Held for sale or disposal.

1. Assets held for use

FASB ASC 360 does not require the contractor to routinely perform cash flow analysis on all of its long-term assets in order to determine if they are fully realizable from future operations. However, the asset should be tested if circumstances, or changes in circumstances, come to the contractor's attention that provides doubt concerning the recoverability of a particular asset.

Some examples of these circumstances or changes in circumstances (per FASB ASC 360) include:

- A significant decline in the asset's market value;
- A significant adverse change in the extent or manner of the asset's use (e.g., a significant decline in the use of the equipment);
- A significant adverse physical change in an asset (for example, physical damage to the equipment);
- Adverse changes in legal factors or the business climate that could affect the value of the asset (for example, the machine suddenly becomes obsolete or changes in environmental regulations significantly restrict the use of a particular piece of equipment);
- Significant overruns beyond the amount originally expected to be needed to acquire or build a piece of equipment;
- A current period operating or cash flow loss combined with a history of operating cash flow losses associated with a particular piece of equipment; and
- A current expectation that it is more likely than not (greater than 50 percent) that an asset will be sold or disposed of prior to the end of its previously estimated useful life.

These (and other) factors alone do not determine if the asset is impaired and a loss should be recognized. However, once the contractor has made the determination that the asset may be impaired, they should then compare the carrying amount of the asset to the undiscounted estimated cash flows for the estimated useful life of the asset for the contractor (NOT the estimated useful life of the asset itself).

Estimates of future cash flows used to test an asset's recoverability should include only the future cash flows directly associated with and expected to arise as a result of the use and disposition of the asset.

FASB ASC 360 provides the guidelines for estimating future cash flows in order to assess impairment by comparing the asset's future cash flows to its current carrying amount. If this projection indicates that the carrying amount of the asset is less than expected future cash flows, the contractor should recognize an impairment loss by reducing the carrying amount of the asset to its current fair value.

What is considered fair value? It is an estimated amount for which the asset could be sold to an unrelated party under current market conditions.

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The following should be noted:

- This is a permanent write-down of the asset and cannot be recovered even if facts and circumstances involving the asset change in future periods;
- The write-down should be accounted for as an actual reduction of the asset, not a valuation allowance; and
- Depreciation should continue to be taken on the remaining useful life of the asset but now based on the new, reduced cost basis.

2. Assets held for sale or disposal

Assets held for sale or disposal may include assets previously held for use or newly acquired assets. The impairment accounting treatment of assets held for sale or disposal is completely different than assets held for use (as previously discussed).

Assets held for sale or disposal should be reported at the lower of the carrying amount of the asset or its fair value less costs to sell (future cash flow projections are not considered). The following should be noted:

- This is not a permanent write-down of the asset. Should facts and circumstances involving the asset change in future periods that indicate an increase in the asset's value, previously recognized losses can be recovered and the asset can be restored to its pre-impairment carrying amount.
- The write-down should be accounted for as a valuation allowance (similar to an allowance for doubtful accounts and contract receivables).
- Since the asset is no longer being held for use, it should no longer be depreciated.

G. Revenue recognition under ASC 606

In 2014, the FASB issued ASU No. 2014-09, codified as ASC No. 606, which became effective as of financial statement periods beginning on or after December 15, 2020, for non-publicly traded entities. This made significant changes to how the entity recognizes revenue according to U.S. GAAP. The following discussion will focus on those items particular to the construction industry.

This is both good and bad news for the CPA industry. The bad news is that the percentage-of-completion method historically used by the construction industry for decades for measuring revenue regarding contracts technically no longer exists under current U.S. GAAP. The good news is that the new standard results in many similarities between the new standard and previous U.S. GAAP. In other words, contractors may be able to recognize revenue under the new standard similar to how they recognized revenue under previous U.S. GAAP using the percentage-of-completion method. In many instances, the impact of the new standard may be small. The most difficult aspect for many companies will be identifying the applicable performance obligations (see step 2 below).

To summarize the new standard, the contractor will be required to go through five steps before they recognize revenue similar to every other industry:

1. Identify contracts with their customers;
2. Identify the various performance obligations associated with the contract;
3. Determine the transaction price associated with the contract;
4. Allocate the transaction price to the various performance obligations; and
5. Recognize revenue when the contractor satisfies a performance obligation.

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We will discuss these five steps as they particularly apply to the construction industry.

1. Identify contract with the customer

In order for a contract to be considered a contract under the new standard, it must meet the following criteria:

- It contains approval and commitment of the involved parties;
- It identifies the rights and payment terms;
- It has commercial substance; and
- Collectability of the contract amount is deemed probable.

Entering into a written contract with a customer is likely to satisfy the first four bullet points. However, it should be noted that most contractors will need to be concerned about the final requirement – collectability. The FASB instructs us that if collectability is not deemed to be probable (a very high threshold), a contract does not exist and accordingly, revenue will not be recognized until all performance related to the contract is complete and all consideration has been collected. Accordingly, this determination of collectability will have to be made by management on a contract-by-contract basis.

2. Identify performance obligations

A performance obligation is a promise in a contract to deliver goods or services to the customer. This may be a single good or service that is distinct or it may be a series of distinct goods or services that are similar and have the same pattern of transfer to the customer over time. Accordingly, they are accounted for as a single performance obligation.

The FASB informs us that a good or service is considered distinct if:

- It benefits the customer on its own;
- It isn't used as an input to produce a combined output;
- It doesn't significantly modify or customize another good or service in the contract; or
- It is not highly dependent or interrelated with other goods or services in the contract.

Example: Oliver Construction, LLC has been contracted to construct a strip shopping center in Highland Park, NJ. Oliver will erect the framing, install the plumbing, HVAC and electrical systems, put up the drywall and perform all of the finishing work. In this situation the various individual tasks are interrelated services – a series of inputs that result in one combined output (the finished shopping center). Although the customer (owner) could likely benefit individually from many of these separate activities, the individual activities are not considered distinct within the context of the entire contract. This means there is one distinct performance obligation in the contract that encompasses all of the highly related activities.

3. Determine the transaction price

The FASB informs us that the transaction price is the total amount of consideration the contractor expects to receive from the contract.

Note:

Credit risk is not considered when making this determination since it was already considered in step 1 when determining whether a contract exists. In most instances (i.e., a fixed-price contract), determining the transaction price is fairly straightforward. However, it becomes much more complicated when variable factors are involved.

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Examples of these variable factors include:

- Liquidated damages;
- Performance bonuses;
- Unapproved change orders; and
- Claims.

The contractor will be required to estimate how much of these variable factors should be included in the transaction price. To do this, the FASB provides the following two methods:

1. The expected value method, which represents a range of possible amounts that are probability weighed and summed; and
2. The most likely value method, whereby the most likely amount in a range of possible outcomes is chosen.

Example: Carson Wentz Contractors is engaged to construct a shopping center under a $20 million fixed-price contract. The contract includes a $1 million bonus if the work is completed on time – by December 31, 20X3. In order to determine the transaction price, Carson Wentz will determine the likelihood of receiving the bonus. In this situation, Wentz has determined that there is an 80 percent chance of the work being completed by December 31, 20X3. Since there are only two outcomes, the transaction price will either be $20 million or $21 million. Since the bonus is considered a variable factor and there are only two factors to choose from, it would make the most sense to utilize the second method – the most likely value method and determine the transaction price to be $21 million since this is the most likely amount.

4. Allocate the transaction price

The next step is to allocate the determined transaction price (step 3) to the various identified performance obligations (step 2). The FASB instructs us that should be done based on a relative standalone selling price basis. If the entity does not sell the performance obligation on a standalone basis, it will need to estimate the standalone selling price. The FASB identifies two methods for estimating the standalone selling price for each identified obligation:

1. Adjusted market assessment approach (also known as the top-down approach – An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. This approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
2. Expected cost plus margin approach (also known as the bottom-up approach) – An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

Note:

There is a third method known as the residual approach. However, the FASB put many restrictions on this method making it, in most circumstances, not a viable option.

However, as we previously discussed under step 2, construction contracts by their very nature are considered to be one performance obligation. Therefore, it will not be necessary to perform this step.

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Example: ***Standalone selling price***

Thompson Contractors agrees to demolish an old sidewalk, lay a new one in the front of a customer's building, and construct a new (unconnected) patio area behind the building. Thompson determines that there are two separate performance obligations in the contract: i) the replacement of the sidewalk; and ii) the new patio. Based on the terms of the contract, Thompson determines that the transaction price is $60,000 and then applies the adjusted market assessment approach to allocate the transaction price to the two distinct performance obligations. Assuming Thompson determines the market value to replace the sidewalk is $44,000 and the market value to construct the new patio is $22,000, the transaction price allocated to each performance obligation would be as follows:

$40,000 to replace the sidewalk – To obtain this amount, Thompson would divide the $44,000 standalone market value by $66,000 (which represents the total of the two components' standalone selling price), which would represent a two-thirds ratio. This ratio would then be used against the total transaction price noted above of $60,000 signifying that $40,000 would be allocated to the sidewalk.

$20,000 to build the new patio – To obtain this amount, Thompson would divide the $22,000 standalone market value by $66,000 (which represents the total of the two components' standalone selling price), which would represent a one-third ratio. This ratio would then be used against the total transaction price noted above of $60,000 signifying that $20,000 would be allocated to the sidewalk.

5. Recognize the revenue

After going through the four steps detailed above, the contractor can now (finally) recognize revenue. Under the new standard, revenue is recognized when or as the various performance obligations are satisfied. The FASB instructs us that revenue will be recognized by one of two methods; either at a single point of time (for products) or over time (for services). A contractor would recognize revenue over time under three scenarios:

1. The customer simultaneously receives and consumes the benefit as the work is performed.
2. The work creates or enhances an asset that the customer controls as the asset is created or enhanced. An example of this would be if a contractor is constructing a building on a piece of land owned by a project owner; the land is being enhanced as the building is being built.
3. The work creates an asset without an alternative use, and an enforceable right to payment exists for performance to date.

A customer recognizing revenue over time needs to determine a measurement of progress towards satisfaction of the performance obligations over time. This can be accomplished using one of two methods:

1. Output methods; or
2. Input methods.

Output methods measure progress towards completion by the result of the work performed. This may be based in the number of units produced, an appraisal of the completed portion, a survey of the performance, or milestones that have been met.

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Input methods measure progress by resources consumed such as labor hours expended, time elapsed, or costs incurred. Note it is this last item that will allow the construction industry to continue to use a method for measuring revenue from its contracts similar to the percentage-of-completion method. Even though (as we just detailed) there are other methods of measuring completion in addition to costs incurred, since these statements will usually be utilized by the surety and the bank, those users will expect the contractor to continue to measure revenues under the historical method of costs incurred.

Example: Chipper Construction was contracted to build an office building in Haddonfield, New Jersey. The following are details concerning this project:

- The contract amount (which was also determined to be the transaction price) was $40 million.
- Total costs were estimated to be $36 million.
- Construction work commenced on July 1, 20X2, and was expected to be completed by June 30, 20X3.
- As of December 31, 20X2, total costs incurred were $9 million.

Since Chipper does not have control over the land or the building, it would appear that Chipper would recognize revenue over time (as opposed to one particular point of time). Chipper identifies the input method as the most appropriate way in measuring its progress of satisfying its performance obligation. Since the $9 million incurred represents 25 percent of the total estimated costs ($36 million), for the period ending December 31, 20X2, Chipper would recognize 25 percent of the transaction price or $10 million.

This example demonstrates that even under ASC 606, contractors may continue to use a method similar to the cost-to-cost percentage of completion method which has historically been used by the construction industry and required by the basic users of the financial statements – the surety and the bank.

However, it should be noted that Chipper was not required to use the cost-to-cost method to measure progress towards completion. As we previously discussed, the FASB allows other methods (i.e., hours expended, etc.) to measure progress towards completion, However, due to the desires of the users, these other options will rarely be used.

IV. Contract assets and liabilities

One of the major changes the new standard has brought us is new terminology on the balance sheet. The two most important new terms we will now have to deal with are contract assets and contract liabilities.

A contract asset is an entity's right to payment for goods and services already transferred to a customer if that right to payment is conditional on something other than the passage of time. For example, an entity (including a contractor) will recognize a contract asset when it has fulfilled a contract obligation but must perform other contract obligations before it is entitled to payment. This is in contrast, to a receivable, which is the right to payment that is unconditional except for the passage of time. Accordingly, in many situations the contractor will reflect on its balance sheet both contract assets and contract receivables. It should be noted that this definition of a contract asset is similar to costs and estimated earnings in excess of billings on uncompleted contracts (underbillings) recognized on the balance sheet under previous GAAP. Accordingly, the new standard will only bring about a classification change on the balance sheet – not a numerical change.

A contract liability is an entity's obligation to transfer goods or services to a customer at the earlier of: (i) when the customer prepays consideration; or (ii) the time the customer's consideration is due for goods

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or services the entity will yet provide. It should be noted that this definition of a contract liability is similar to billings in excess of costs and estimated earnings on uncompleted contracts (overbillings) recognized on the balance sheet under previous GAAP. Accordingly, the new standard will only bring about a classification change on the balance sheet – not a numerical change.

A. Retainage

Under previous U.S. GAAP, retainage was considered a contract receivable as the project progresses. Topic 606 defines a contract asset as "an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance)." Relatedly, ASC 606-10-45-4 says "a receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due." Therefore, in order to properly classify retainage, an evaluation needs to be made as to whether it is conditional or unconditional.

Frequently, retainage is subject to other conditions, besides the passage of time, like performance metrics or milestones. In these situations, retainage should be included in contract assets or liabilities (as determined at the contract level). Once the entity's rights to receive the retainage become unconditional (that is, only passage of time is required before payment comes due), it should then be classified as a receivable.

V. Leases under ASC 842

In 2016, the FASB issued ASC 842, *Leases*, which became effective for financial statement periods beginning on or after December 15, 2021, for non-publicly traded entities and has resulted in significant changes on how an entity recognizes and presents its leases according to U.S. GAAP.

The previous GAAP guidance for leases was FASB ASC 840, *Leases*. Two categories of leases were identified by the ASC:

1. An operating lease; and
2. A capital lease.

Under an operating lease, the lessee records rent expense over the lease term in the income statement as a debit to an expense account. Under a capital lease, the lessee does not record rental payments as an expense. Rather, the rent is classified as interest and obligation payments similar to a mortgage (with the interest calculated with each rental period on the outstanding obligation balance). At the same time, the asset is depreciated (amortized). If the lease has an ownership transfer or bargain purchase option the depreciable (amortizable) life is the asset's economic life; otherwise, the depreciable (amortizable) life is the lease term. Over the life of the lease, the combined interest and depreciation (amortization) will be equal to the rent payments. Capital leases are reported on the lessee's balance sheet as an asset under property, plant, and equipment, and as a liability (capital lease liability). The amount recorded by the lessee as an asset and obligation under a capital lease is the present value of the minimum lease payments during the lease term, excluding executor costs (defined as those expenses typically associated with owning the asset and would include real estate taxes, maintenance, and insurance) which are currently expensed by the lessee.

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The discount rate used to determine the present value of the minimum lease payments would be the lesser of the following two rates:

1. The lessee's incremental borrowing rate; or
2. The implicit rate use by the lessor.

According to FASB ASC 840, a lease would be classified as a capital lease if any one of the following four tests is met:

1. The lease conveys ownership from the lessor to the lessee at the end of the lease;
2. The lessee has an option to purchase the asset at a bargain price at the end of the lease term;
3. The term of the lease is 75 percent or more of the economic life of the asset; or
4. The present value of the rents, using the lessee's incremental borrowing rate, is 90 percent or more of the fair market value of the asset.

Otherwise, the lease would be reflected solely on the income statement of the lessee as an operating lease by the lessee.

The accountant should be aware of the importance of having a solid understanding of FASB ASC 840 and the criteria for classification of a lease. Improperly classifying leases will result in (possibly material) improper presentation of both the balance sheet and the income statement.

However, it should be noted that in February of 2016, the FASB issued ASU 2016-02 – *Leases*, Topic 842, which is now effective and has resulted in an overhaul of how the accounting profession accounts for leasing transactions. The FASB explained that this Update was issued in order to increase transparency and comparability among entities by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

The FASB's position is that the previous standard (ASC 840) did not provide the users of the financial statements with a "faithful representation of leasing transactions." In particular, it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. As a result, the FASB has represented that there have been long-standing requests from the users of the financial statements to change the accounting requirements so that lessees would be required to recognize the rights and obligations resulting from leases as assets and liabilities.

This ASC has not changed the accounting from the lessor's perspective, but from the lessee's perspective; the concept of operating leases (where all lease payments go directly to the income statement) has substantially been eliminated and virtually all leases will be required to be accounted for as capital leases.

This ASC will affect any entity that enters into a lease (with some exceptions). It became effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for any of the following:

- A public business entity;
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market; and
- An employee benefit plan that files financial statements with the SEC.

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For all other entities, this ASC will be effective for fiscal years after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

The impact this ASC is having on the construction industry is significant. Contractors are typically associated with leases as lessees for:

- Construction equipment;
- Office equipment;
- Vehicles; and
- Office space.

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Preparing Construction Contractor Financial Statements

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Preparing Construction Contractor Financial Statements

Learning objectives

Upon reviewing this material, the reader will be able to:

- Identify how contractor-related financial statements are utilized by and relied upon by the surety and other users;
- Recall what disclosures should be included with the financial statements when they will be utilized by and relied upon by the surety and other users; and
- Recognize additional disclosure requirements under ASC 606.

I. Introduction

Every financial statement that an entity prepares must not only have U.S. GAAP in mind, but also the specific needs of the users of those statements. Regarding construction industry financial statements, the major users usually include:

- The surety (in most instances, the principal user);
- The bank;
- Other asset-based lenders;
- The bond agent; and
- Investors of the entity.

Since, in most instances, the surety is the principal user of the financial statements, this chapter will be presented considering their particular needs.

As we discussed in Chapter 2, beginning with years ending on or after December 15, 2020, (for private companies), FASB ASC 606, *Revenue from Contracts with Customers*, became effective. As we will now discuss, its major impact on the contractor financial statement will be name classifications on the balance sheet. We no longer have costs incurred in excess of billings and earnings on uncompleted contracts (underbillings) or billings in excess of costs incurred and estimated earnings on uncompleted contracts (overbillings). Instead, those two terms are replaced with contract assets and contract liabilities (whose definitions were discussed in Chapter 2).

II. In general

Most sureties do not require comparative financial statements. Accordingly, the contractor should prepare only a single-period financial statement. Note that if the surety or management does require comparative financial statements, the preparer of the financial statements should be sure to oblige this request.

Regarding the level of assurance required by the surety from the outside CPA, most sureties will generally use criteria based on the contractor's revenues. For example, less than $1,000,000 of revenue may only require a copy of the contractor's income tax return, between $1,000,000 and $5,000,000 of revenue, the surety may only require a compilation, between $5,000,000 and $10,000,000 of revenue, a review report, and over $10,000,000 of revenue, the surety may require an audit.

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III. The balance sheet

The balance sheet is almost always made use of and relied upon by the users of the financial statements. Accordingly, this statement must be presented in the format as needed by the surety. Some of those format presentations include the following:

a. Since the surety will usually consider the contractor's current ratio, the contractor should present a classified balance sheet separating current assets and liabilities (as defined by U.S. GAAP) from noncurrent assets and liabilities.

b. Regarding the entity's contract receivables, the following are items that the contractor should consider disclosing in order to assist the surety in its underwriting process:

(i) The contractor should ascertain that retention held back by and owed by the owner is reported separately from billed amounts.

(ii) Many sureties will expect to see the contract receivables presented on an aging basis. The surety will analyze this schedule to assist them in determining the collectability of the contractor's receivables.

(iii) The contractor should review their receivable schedule and write off any amounts that are deemed uncollectable. The contractor should know that the surety will generally not provide working capital credit for any receivable greater than 60 days. At the same time, the surety will probably have concerns when significant amounts of seriously past-due amounts are reflected on an aged receivable schedule.

(iv) In addition, the contractor should be sure to clearly disclose the allowance for doubtful accounts related to their contract receivables.

(v) The contractor should be sure to disclose any receivables due from related entitles.

Note:

Since the surety will not give the contractor working capital credit for any receivables due from related entities (both the current and long-term portions); it would make business sense for the contractor to attempt to collect those receivables prior to the balance sheet date. This will accomplish two things: (i) it will remove a disallowed receivable from the contractor's books; and (ii) it will improve the contractor's cash position if they are able to actually collect the receivable.

Note:

The calculation of working capital for surety underwriting purposes will be discussed in greater detail in Chapter 5.

(vi) Although not required by U.S. GAAP, the contractor may want to disclose to the surety the amount of balance sheet date receivables collected subsequent to the balance sheet date.

(vii) The contractor should disclose the amount (if any) of contract receivables which are expected to be collected more than one year after the balance sheet date (necessitating that they be classified as a long-term asset rather than a current asset).

(viii) The contractor should ascertain that there was a proper cutoff of reported contract receivables as of the balance sheet date.

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c. Regarding the contractor's notes receivable:
   (i) The financial statements should be sure to break out the current portion of the receivable from the long-term portion;
   (ii) The financial statements (or the footnotes) should disclose if any of these amounts are due from related entities; and
   (iii) The financial statements (or the footnotes) should disclose management's position on the collectability of the note including any collateral.

d. If the contractor owns inventory as of the balance sheet date, the financial statements should be sure to disclose:
   (i) How the inventory was priced (cost, lower of cost or market, etc.); and
   (ii) How the inventory was valued (FIFO, LIFO, etc.).

e. The entity should be sure to clearly disclose its contract assets (i.e., costs and estimated earnings on uncompleted contracts in excess of billings).

Note:

U.S. GAAP requires that contract assets and contract liabilities are reported gross on the balance sheet. In other words, the contractor should not net these two amounts together and report the excess as either an asset or liability.

f. Similar to its contract receivables, the following are items in relation to its contract payables that the contractor should consider disclosing in order to assist the surety in its underwriting process:
   (i) Retention – The contractor should ascertain that all retention held back from and payable to subcontractors is reported separately from amounts currently due;
   (ii) The contractor should ascertain that all of their valid payables are reflected on the payable schedule and that there has been a proper cutoff as of the balance sheet date;
   (iii) If significant, the financial statements should disclose the amounts due to subcontractors that are included in the contract payables balance;
   (iv) If any payables are due to be paid later than one year, the fact that they are considered a long-term payable should be disclosed; and
   (v) The contractor should be sure to disclose any payables due to related entitles. (Note that related-party transactions will be discussed later in this chapter.)

g. One particular area that contractor financial statements have resulted in material U.S. GAAP errors is how the entity's debt is reported on its balance sheet. In particular, the contractor must be sure to properly allocate the entity's debt between current and long-term portions. It should be noted that this issue is a critical factor in the surety's underwriting function because of the impact a misallocation would have on computing the contractor's current ratio as well as other benchmarks the surety may utilize. Note that the contractor (along wither their outside CPA) must be aware of situations when U.S. GAAP (FASB ASC 470, *Debt*) requires previously presented long-term debt to be reclassified as a current liability (scheduled to mature within one year of the balance sheet date). One of these situations that both the contractor and their outside CPA will occasionally fail to consider is if in fact the entity is not in compliance with the various covenants detailed in the debt agreements. If in fact the contractor is not in compliance with these provisions, the lender has the ability to immediately call the debt. Under this situation, U.S. GAAP requires this type of debt to be presented as a current liability.

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h. The balance sheet should report any accrued anticipated contract losses when applicable (as discussed in Chapter 2).

i. Similar to contract assets, the balance sheet should disclose any contract liabilities (formerly known as overbillings or billings in excess of costs and estimated earnings on uncompleted contracts).

j. Various other accrued expenses that could have a significant impact on the contractor's financial statements. These may include the following.

   (i) Liability and workers' compensation insurance (this will be discussed in more detail later).

   (ii) Any contingent liability the contractor may be responsible for if its realization is deemed to be probable and the amount of expense related to the liability can be reasonably estimated. Some examples of contingent liabilities that often impact contractors include the following:

   - Pending or threatened lawsuits.
   - The contractor's obligation under outstanding surety bonds. Note that an example format of this disclosure will be presented later in this chapter.
   - Obligations related to warranties or defects.
   - Guarantees of indebtedness of others.

Note:

The issue of the contractor guaranteeing another entity's debt is one requiring financial statement disclosure. A number of sureties have incurred significant loses as the result of this particular issue of nondisclosure. The surety would provide bond credit to a contractor unaware of this contingent liability. Subsequently, the guarantee would kick in, requiring the contractor to pay off this debt by taking money off its bonded jobs, ultimately resulting in a loss to the surety.

Note that contingent liabilities are often a concern for virtually every line of business, but particularly for the construction industry. According to U.S. GAAP (FASB ASC 450, *Contingencies*), these loss contingencies should be divided into three categories, based on the probability that the existence or failure of the future event will confirm the loss.

- **Probable** loss contingences are ones for which the loss is deemed by management to be highly probable. If the amounts can be reasonably estimated, they must be accrued as of the balance sheet date. In addition, proper footnote disclosure should be made. If the amount of the loss cannot be reasonably estimated, no accrual is required, but this fact should be disclosed.
- **Reasonably possible** loss contingencies are those for which the possibility of loss falls between probable and remote. Although no accrual is required, this type of contingency must be disclosed.
- **Remote** loss contingencies are those for which the risk of loss is considered to be unlikely. No accrual or disclosure is required.

It should be noted that there is one exception to the rule concerning a remote possibility of loss requiring no disclosure or accrual that deals with the issue of the guaranteeing of others indebtedness. U.S. GAAP always requires disclosure of this particular contingent liability no matter how remote a loss related to the debt could happen.

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A. Insurance accruals

Many contractors may not be aware of the issue involving the possibility of having to accrue additional insurance expense as of the balance sheet date. In particular, there are two types of insurance that generally should be a concern to the contractor:

- Workers' compensation; and
- Liability.

1. Workers' compensation

This type of insurance is based on the entity's payroll with different premium rates assigned to the various classifications of the contractor's employees (construction-related employees will generally be charged a higher rate than office workers due to the higher probability for claims). The original premium the insurance company charges is an estimate generally based on the contractor's prior year payroll. At the end of the premium period, the insurance company will perform an audit to determine the actual payroll incurred during the current premium period. If the entity's payroll decreased in the current premium period as compared to the prior premium period, they may be due a refund from the insurance company. Conversely, if the entity's payroll increased during the current premium period over the prior premium period, then they will owe the insurance company an additional premium.

2. Liability

The premium issues associated with workers' compensation insurance are also applicable to the entity's liability insurance with the exception being that whereas the workers' compensation premium is based on the contractor's payroll, the liability insurance premium is often based on revenues.

For the construction industry, insurance accruals are ones that could be a concern for many entities (especially workers' compensation insurance for those that are labor-heavy). With the possible exception of when there is an economic slowdown in the construction industry, in most years, payroll and revenue increases in the current year as compared to the prior year. Accordingly, most contractors have to deal with the issue of recognizing an additional insurance expense.

It should be noted that this additional insurance expense is in actuality an accrual and, for many contractors, the amount of this accrual could be significant. It should also be noted that historically, a number of sureties have incurred significant losses because they relied upon financial statements that did not record these accruals, which resulted in a significant underreporting of their insurance expense and current liabilities, and an overstatement of both their gross profit and net income.

IV. The income statement

Similar to the balance sheet, the contractor's income statement is almost always made use of and relied upon by the users of the financial statements. Accordingly, this statement must be presented in the format as needed by the surety. Some of those presentations include:

- The amount of contract revenues earned by the entity;
- The amount of costs of revenues earned;
- The amount of recognized gross profit; and
- General and administrative expenses.

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V. Statement of cash flows

A statement of cash flows for a contractor is similar to other entities. Accordingly, there are no special disclosure requirements for the contractor. However, it should be noted that although U.S. GAAP (FASB ASC 230, *Statement of Cash Flows*) allows the entity to present cash flows from operating activities using either the direct method or the indirect method, since most users of the contractor's financial statements (surety and bank underwriters) are accustomed to working with the indirect method, in most instances, this may be the preferable method to be used.

VI. Footnote disclosures related to the contractor's financial statements

Because the footnote disclosures are considered an integral part of the financial statements in order to allow the reader (i.e., the surety and the bank) to obtain a better understanding of those statements, they must be written in language that will be understood by the users of the financial statements. In addition, the contractor should ascertain that all amounts included in the footnote disclosure agree with the related amounts in the financial statements (for example, contract assets, contract liabilities, and contract receivables).

A. Disclosures that are often critical

Some of the disclosures that are often critical for the construction industry include the following.

1. Nature of operations

The disclosure should inform the reader:

- Who the contractor is;
- Where they are located; and
- How they earn their revenues – what product or service is provided, i.e., construction.

2. Significant accounting policies

Many of the disclosures involving the contractor's significant accounting policies are similar to other entities. Therefore, only those that may be of interest to the surety will now be listed.

- **Subsequent events** – U.S. GAAP (FASB ASU 2010-09, *Subsequent Events*) requires the disclosure of/through which date subsequent events were considered and either accrued as of the balance sheet date or disclosed in the financial statements. Note that this date should correspond with the accountant/auditor's report date.
- **Contract receivables** – The method utilized by the contractor in determining the allowance for doubtful accounts must be disclosed to inform the surety regarding the realization of its reported contract receivables.

Note:

U.S. GAAP requires the use of the allowance method, NOT the direct write-off method which is used for the entity's income tax preparation. The reason being that under the allowance method, the contractor may recognize the bad debt expense in an earlier period than utilizing the direct write-off method, Therefore, inappropriately using the direct write-off method could result in an understatement of its bad debt expense and an over reporting of its net income. The only exception to this requirement is if the two amounts do not materially differ.

- A definition and description of contract assets and contract liabilities (discussed in Chapter 2.)

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3. Use of estimates

Every financial statement is prepared utilizing at least one estimate made by management. However, contractor financial statements require numerous estimates in their preparation. Therefore, U.S. GAAP requires that the financial statements disclose that some of the numbers included in the financial statements may be little more than guesses made by management and may be subject to change in future periods. In addition, if there were significant revisions in contract estimates, this fact should also be disclosed.

4. Revenue recognition

As discussed in Chapter 2, there are now changes in how contractors recognize revenue on their long-term contracts (including change orders and claims as discussed in Chapter 4). These changes will be effective for virtually every contractor's annual financial statement periods beginning on or after December 15, 2020.

The following will now need to be disclosed:

a. **Disaggregation** – FASB ASC 606 requires that revenue be disaggregated into categories that help users determine the nature, amount, timing and uncertainty of revenue and cash flows. Multiple categories may be necessary. In addition, the standard requires companies to disclose how they chose those categories. When making the determination what to include in the disaggregation, the most important consideration is what the users (surety or bank) would want included. The FASB provides the following potential categories:
   - Type of good or service (product or services lines);
   - Geographical regions (county or region);
   - Type of contract (fixed price or time and material);
   - Contract duration (short term vs. long term);
   - Market or type of customer (government or nongovernment);
   - Timing or transfer of goods or services (at a point of time or over time); and
   - Sales channels (directly to customers or through intermediaries).

b. **Contract balances –** Contractors are required to report contract assets separately from contract receivables on the balance sheet. As we discussed in Chapter 2, a contract asset is an unbilled amount while a receivable is an amount billed but not collected. A contract liability is created when a customer prepays before the contractor completes all of its obligations. It should be shown separately from contract payables which represents amounts incurred but not yet paid.

c. **Significant judgments** – All contractors (both publicly traded and private) are required to disclose judgments and changes in judgments that significantly affect the amount and timing of revenue from customer contracts. This includes the timing of satisfaction of performance obligations and the transaction price and amounts allocated to performance obligations. All contractors must also disclose the methods, inputs, and assumptions made whether an estimate of variable consideration is constrained. Publicly traded contractors have additional disclosure requirements not detailed here.

d. **Transition method** – The contractor will need to disclose the method used (full retrospective or simplified approach) when transitioning to FASB ASC 606. This disclosure only applies in the year of transition.

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5. Unapproved change orders and claims

Even though many contractors along with their outside CPA have taken the position that no revenue should be recognized from a change order or a claim until it has been approved for both the price of the change order and the scope of the work to be performed (for the change order) or until receipt of the proceeds (regarding a claim), there may be situations where the contractor may recognize revenue and the related contract receivable issues in relation to an unapproved change order or an open affirmative claim.

Note that the issue of unapproved change orders and claims under ASC 606 will be discussed in much more detail in Chapter 4.

6. Contract receivables

In addition to those items mentioned earlier in this chapter, the financial statements should also disclose to the reader a breakdown of the entity's receivables as of the balance sheet date. A suggested format might be as follows.

As of December 31, 20X2, the entity's contract receivables consisted of:

Completed contracts	$1,000,000
Contracts in progress	800,000
Retention	200,000
	2,000,000
Less: allowance for doubtful accounts	(100,000)
	$1,900,000

7. Contract assets and contract liabilities

In addition to those items noted earlier in this chapter dealing with the contractor's contract assets and contract liabilities, the footnote disclosure should also provide the surety with details concerning these items.

8. Contingent liabilities

What is a contingent liability (as defined by U.S. GAAP)? It is an existing condition that may create an obligation in the future but that arises from past transactions or events.

In regard to preparing its financial statements, the contractor has three concerns in relation to its contingent liabilities:

- Have all contingent liabilities been identified?
- Have they have been properly valued for financial statement reporting purposes?
- Have they have been properly disclosed in the financial statements?

What are some of the more prevalent contingent liabilities impacting the construction industry?

- Any obligations the contractor may have regarding product or other warranties.
- The contractor's obligation under outstanding payment and performance surety bonds (to be discussed next).
- Pending or threatened lawsuits.
- Guaranteeing the debt of others.
- Environmental concerns.

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Note:

Environmental concerns have become much more prevalent as public and governmental awareness of environmental damage caused by construction work becomes more pronounced.

An example for disclosing contingent liabilities is now presented:

> From time to time, the entity is involved in routine litigation that arises in the ordinary course of business. There are no pending significant legal proceedings to which the entity is a party for which management believes the ultimate outcome would have a material adverse effect on the entity's financial position.

9. Surety bonds

Because of its importance and the fact it impacts most contractors, the issue of the contractor's outstanding surety bonds will be expanded upon. If the entity is obligated to the surety under payment and performance bonds, this fact should be disclosed in the financial statements. A sample disclosure is now presented:

> The entity, as a condition to entering into some of its construction contracts, had outstanding payment and performance surety bonds as of December 31, 20X2. The surety bonds are secured by the entity's bonded contract balances and personally guaranteed by the stockholders of the entity.

10. Commitments

Whereas contingencies arise from past transactions, commitments are associated with transactions that will impact the contractor in the future. Probably the most important commitment involving the construction industry is leases since most contractors are obligated for office and equipment leases.

U.S. GAAP (FASB ASC 840, *Leases*) requires the following disclosures for operating leases with terms in excess of one year the contractor may be obligated for:

- Future minimum rental payments required as of the balance sheet date, in the aggregate, and for each of the next five years;
- Total of minimum rentals to be received in the future under noncancelable subleases;
- Rental expense with separate amounts for minimum rentals, contingent rentals, and sublease rentals; and
- A general description of the leasing arrangements, including the basis of contingent rental payments determination, any renewal or purchase option, and any restrictions.

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The following is a sample format disclosing future lease commitments:

Example: The entity leases various types of office and construction equipment and other facilities generally over periods up to seven years. All of the leases are accounted for as operating leases. At December 31, 20X2, the future minimum rental payments under these operating leases are as follows:

20X3	$500,000
20X4	500,000
20X5	300,000
20X6	200,000
20X7	200,000
Thereafter	400,000
Total	$2,100,000

Lease expense under operating leases totaled approximately $600,000 in 20X2.

As discussed in Chapter 2, changes to how contractors account for and report their leases became effective (for non-publicly traded entities) for financial statement periods beginning on or after December 15, 2021.

11. Concentrations

An occasionally overlooked but often important disclosure involves any concentrations associated with the contractor. There are generally three types of concentrations that are usually an interest to the surety:

- **Major customer** – If a significant portion of the contractor's revenues are derived from a small number of customers (owners in the case of a contractor), the surety would be more concerned in this situation than if its revenues were derived from numerous owners since the decline in the relationship or any financial demise of one or more of these owners would put the contractor at more of a risk than if there was a diversification of revenues among numerous owners. In fact, U.S. GAAP requires a major customer disclosure if any single customer comprises at least 10 percent of the contractor's revenues.
- **Geographic locations** – The surety would be less concerned if the contractor's revenues were derived in numerous geographic locations rather than concentrated in one area because if any adverse occurrence happens in that particular location (for example, Hurricane Sandy, a regional economic slowdown, etc.), it would impact the contractor more if all of their work is performed in that one area (for example, New Jersey or New York City) as compared to a contractor who performs their work in numerous locations and would not be.
- **Type of work performed** – If all of the contractor's revenues were derived from one source (for example, road work), then if there was an economic slowdown of work to be performed in this area, it may cause more of a problem for this type of contractor as compared to one that works in numerous fields.

A sample of the concentration disclosure is now presented:

> Approximately 80 percent of the entity's revenues are earned from road building earned in the Philadelphia metropolitan area. In addition, approximately 60 percent of the entity's revenues were earned from the City of Philadelphia and the Pennsylvania Department of Transportation.

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12. Related-party transactions

When a contractor is directly or indirectly owned or controlled by another entity or under common control of another entity, related-party considerations usually are of significant concern. U.S. GAAP (FASB ASC 850, *Related-Party Disclosures*) notes that related-party transactions will often cause the surety and other users of the financial statements a high level of concern because transactions involving related parties cannot be presumed to be carried out on an arm's-length basis as the requisite conditions of competitive, free-market dealings may not exist. Accordingly, when they exist, they should be disclosed in the contractor's financial statements.

What are some examples of related parties that may impact the construction industry?

- Transactions between a parent and its subsidiary;
- Transactions between the contractor and its principal shareholder/partner, management, or their immediate families; and
- Transactions between the contractor and trusts for the benefit of its employees such as pension, profit-sharing, and other retirement plans.

In regard to the construction industry, in many instances there tend to be numerous related parties. These may include:

- The owner/lessor of the contractor's office space; and
- The owner/lessor of the contractor's equipment.

What are some examples of related-party transactions that may be applicable to the construction industry?

- Sales, purchases, and transfers of real and personal property;
- Services received or furnished (including personal services such as legal, accounting, etc.);
- Any construction-related services the contractor may supply;
- Use of property and equipment by lease;
- Borrowings and loans;
- Guarantees; and
- Intercompany billings based on allocations of common costs.

When a contractor does in fact have significant related-party transactions, what should be disclosed in their financial statements?

- The nature of the relationships involved.
- A description of the transactions, including transactions to which no amounts were ascribed.
- The dollar amounts of these transactions.
- Amounts due from or to these related parties as of the balance sheet date.
- Control relationships even if no transactions occur between and among the commonly controlled entities.

13. Backlog

As will be expanded upon in more detail in Chapter 5 when discussing the surety's use of the contractor's financial statements, backlog is one of the more important disclosures that the surety relies upon when making a bond credit decision. It should be noted that although backlog is currently not a required disclosure under U.S. GAAP, since it is widely acknowledged that it is a disclosure utilized by the surety and other users of the financial statements, most contractors will include this disclosure since, as was

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mentioned earlier in this chapter, financial statements should be prepared considering the needs of the chief users of those statements

What is backlog? Per U.S. GAAP (FASB ASC 275, *Risks and Uncertainties*), this amount is derived from two different sources:

- Any remaining contract revenues to be earned from the contractor's work-in-progress as of the balance sheet date, plus
- Any contract revenue to be earned from contracts entered into (and whose cancellation is not expected) between the balance sheet date and the date of the release of the financial statements.

Note:

Included in this definition of entered into are any letters of intent the contractor receives from the potential owner. However, if revenue from the letters of intent is included in disclosure, they should be shown separately from signed contracts.

A sample disclosure format for presenting backlog is as follows.

Example: The following schedule presents a reconciliation of backlog representing the amount of revenue the entity expects to realize from work to be performed on uncompleted contracts in progress as of December 31, 20X2, and from contractual agreements entered into between January 1, 20X3 and March 15, 20X3:

Balance as of December 31, 20X1	$10,000,000
Contract adjustments	1,000,000
Revenue from contracts entered into in 20X3	4,000,000
	15,000,000
Less: contract revenues earned in 20X2	(12,000,000)
Balance as of December 31, 20X2	$3,000,000

14. Going concern

The issue of going concern will be discussed in more detail in Chapter 5 (when dealing with the surety's underwriting process related to going concern).

However, for now, an example of financial statement disclosure in both the auditor/accountant's report and the footnote disclosures regarding going concern tailored for the contractor will be presented.

Example: ***Accountant/auditor's report***

The accompanying financial statements have been presented assuming the Entity will continue as a going concern. As discussed in Note A to the financial statements, the Entity has suffered recurring losses from operations, significantly lower gross profit, negative cash flows from operating activities, a decreasing backlog, and has a capital deficiency that raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note A.

The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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Example ***Footnote disclosure***

Note A – Significant Accounting Policies (partial)

Basis of Presentation

The accompanying financial statements have been prepared on a going concern basis which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As shown in the accompanying financial statements, the Entity incurred significant operating losses from continuing operations of $800,000, recognized significant losses on a number of its construction contracts, and used cash in its operations of $900,000. In addition, the entity was unable to obtain any new bond credit from its surety in 20X2. These factors, among others, indicate that the Entity may be unable to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification that might be necessary should the Entity be unable to continue as a going concern.

Management recognizes that the Entity's continuation as a going concern is dependent upon its ability to generate sufficient cash flow to allow the Entity to satisfy its obligations on a timely basis. The generation of sufficient cash flow is dependent on the Entity's ability to obtain future bond credit from its surety, and its ability to obtain profitable nonbonded work. In addition, the Entity plans to engage the services of a consultant to assist Management in significantly reducing its General and Administrative expenses (overhead). The Entity expects to achieve these initiatives without disrupting those activities necessary to complete its construction projects. Management believes that the successful achievement of these objectives combined with the ability to continue to utilize its bank line-of-credit should provide the Entity with sufficient resources to meet its short-term cash requirements. In addition, the Entity is considering a number of other strategic alternatives; however, no assurance can be made with respect to the viability of the Entity.

VII. Schedules of supplementary information

When discussing contractor financial statements and supplementary information, there are generally two classifications of this additional information that the surety will utilize when making a bond credit decision:

- Job schedules; and
- Other schedules.

A. Job schedules

The job schedules are probably the single most important component of the contractor's financial statements the surety will focus on when making a bond credit decision. Job schedules will generally include:

- A schedule of contract revenues earned (combining the next two schedules);
- A schedule of contract revenues earned from contracts completed during the reporting period; and
- A schedule of contracts in progress as of the balance sheet date reporting contract revenues earned during the reporting period, gross profit earned from those contracts during the reporting period, and contract assets and contract liabilities on the jobs-in-progress as of the balance sheet.

The contractor should ascertain that all totals included in these schedules agrees to the corresponding amounts on the balance sheet and income statement (contract revenues, costs of revenues earned, gross profit, contract assets and contract liabilities, etc.).

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B. Other schedules

Other schedules the surety will generally expect to have included in the financial statements include:

- A schedule of costs of revenues earned; and
- A schedule of general and administrative expenses.

The surety will analyze the detail of these schedules looking for any amounts that may be unreasonable or excessive (in particular, officer compensation).

And similar to the job schedules, the contractor should ascertain that the totals of each of these two schedules agree with their corresponding amounts on the income statement.

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Change Orders and Claims

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Change Orders and Claims

Learning objectives

Upon reviewing this material, the reader will be able to:

- Define change orders and claims related to the construction industry;
- Identify when revenue should be recognized from a change order; and
- State when revenue should be recognized from a claim.

I. Introduction

Due to complexity, many contractors violate U.S. GAAP in the area of proper revenue recognition and financial reporting. Change orders and claims are integral parts of the financial reporting of most contractors. We will begin by discussing what these terms mean, then discuss them within the context of proper revenue recognition.

II. Change orders

A. What is a change order?

A change order is a clause in the contract that permits additions, deductions, or changes to the contract after work has commenced. It can be initiated by either the contractor or by the owner and can either increase or decrease the original contract amount.

Example: Eskin Construction was contracted by the Pennsylvania Department of Transportation (the owner) in the amount of $10,000,000 to widen a portion of the Pennsylvania Turnpike. After work had commenced, the owner decided to add additional curbing not included the original contract in the amount of $1,000,000. This addition is known as a change order.

U.S. GAAP (FASB ASC 606) is considered by many CPAs to be very difficult to understand regarding when the contractor should recognize revenue from change orders, especially unapproved change orders. In theory, the contractor should be able to recognize the revenue associated with an unapproved change order when management considers realization of the change order to be probable (as we discussed in Chapter 2).

1. What does the FASB mean by probable?

Some of the indications that realization of the change order would be considered probable are:

- The contractor has had historical experience providing probable assurance of realization as noted above.
- The contractor has received a bona fide pricing offer from a customer and records only the amount of the offer as revenue.

Practically speaking though, the contractor should recognize revenue from an unapproved change order only when it has been approved by the owner for both the scope of the work to be performed and the price the owner will pay for the additional work. If approval for both the price and scope of the change order has not been obtained by the contractor, then no revenue should be recognized because the change order is still unapproved. However, all costs associated with the additional work should be expensed as incurred.

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If a change order remains in dispute (if it does not eventually get approved by the owner regarding both its scope and price), then it will often evolve into a claim, which will be discussed more below.

2. What causes an unapproved change order?

Say, while Eskin Construction was performing the Turnpike job referred to above, an engineer (design professional) engaged by the owner provided the contractor with a verbal approval for additional work to be performed over a weekend assuring Eskin that a written change order would be issued the following Monday. However, when Monday arrived and Eskin requested their change order, they were informed by the owner that the additional work was either not authorized or the cost of the work performed by Eskin was greater than what was authorized. In this situation, Eskin has what U.S. GAAP refers to as an unapproved change order for which no revenue should be recognized until approval is obtained for both the scope of the work to be performed and price of the change order. However, all expenses incurred by Eskin related to the additional work must be currently expensed (since they were still incurred).

Obviously, it makes business sense for the contractor (whenever both feasible and practical) to avoid the performance of additional work without first obtaining written approval from the owner detailing both scope and price for that work. However, this is not always possible. Since change orders are so common in the construction industry, it is important to discuss how they will be treated under the revenue standard (FASB ASC 606).

How change orders are accounted for depends on whether they are considered distinct from the original contract. A distinct change order utilizes standalone pricing. It is separate from the performance obligations outlined in the original contract and therefore results in a new contract. On the other hand, a continuation change order is considered to use add-on pricing from the original contract; and is interdependent with the work promised in the original contract, thus creating a cumulative obligation (i.e., it is not a new contract).

III. Claims

A claim, in the language of the CPA profession, usually refers to an affirmative claim – action brought by the contractor against the owner often resulting in litigation.

What causes a claim? It is usually caused by unforeseen circumstances that the contractor could not have avoided. These unforeseen circumstances include:

- Delays caused by the owner;
- Errors in the original design of the project;
- Disputed liquidated or other damages assessed by the owner;
- Disputed contract terminations; and
- Unapproved change orders that could not be resolved by nonlitigation means.

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As discussed in Chapter 2, the manner in which revenue is recognized has changed beginning with financial statement periods beginning on or after December 15, 2020, including how a contractor recognizes revenue from change orders and claims. In theory, the contractor will be able to recognize revenue when collection of these amounts is considered probable. However, in practice, most CPAs consider both unapproved change orders and claims to be contingent gains whereby no revenue should be recognized until the gain is realized. This is based on the position discussed previously, that the surety and the bank (that is, the users of the financial statements) do not want contractors recognizing revenue from an unapproved change order or from a claim until cash is actually received. This is also consistent with conservative accounting principles for revenue recognition.

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The Surety, the Contractor, and the Outside CPA

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The Surety, the Contractor, and the Outside CPA

Learning objectives

Upon reviewing this material, the reader will be able to:

- Recognize how the surety industry impacts the construction industry;
- Define the term surety and recognize how it operates;
- Recognize the different types of bonds the surety is associated with;
- Recall how the surety interacts with other components of the construction industry;
- Identify the bond agent's role in the construction process;
- Identify how the surety determines which contractors receive bond credit via their underwriting standards;
- Define profit fade and job borrow;
- Recognize the early warning signals that could be an indication to the surety of a failing contractor;
- Identify how the surety deals with a troubled contractor; and
- Recognize the role that the CPA plays in the relationship between the contractor and the surety.

I. The surety and its impact on the construction industry

If the construction industry is the engine that runs the United States economy, then the surety industry is the gasoline that powers that engine. When the surety industry is strong and there is sufficient bond credit available, the construction industry can thrive and grow. Conversely, when the surety market is experiencing weaknesses, it usually has a negative impact on the construction industry.

In many instances, the surety is the primary user of the contractor's financial statements. Therefore, when the contractor prepares its financial statements, the needs of the surety must be always considered.

II. What is a surety and how does it operate?

A surety is not an insurance policy, it is a guarantor. The surety guarantees completion of a contract according to the terms of that particular contract. Even though many sureties are associated with insurance companies, in reality, it is much closer to a banking function.

It could be compared to a letter of credit issued by a bank. This letter of credit (similar to a surety bond) will stay in the background and only come into play if a certain transaction does or does not happen (in the case of the construction industry, the surety would step in if the contractor is not able to fulfill the terms of the construction-related contract).

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III. How a surety operates

The typical surety will usually consist of three departments:

1. **Underwriting** – Responsible for determining which contractors receive bond credit. In other words, the revenue producers of the surety.
2. **Claims** – Not only responsible for paying out on claims related to payment bond and performance bond obligations, but also responsible for determining the validity of the claim and attempting to reduce the amount actually paid (especially in the area of performance obligations).
3. **Recovery** – Responsible for recovering losses incurred for the surety (amounts paid under payment and performance obligations). A properly run recovery department will not only attempt to collect from traditional sources, such as corporate and personal guarantors, but also from nontraditional sources, such as attempting to prove CPA malpractice when the underwriters issued bond credit based on their reliance on CPA audited or reviewed financial statements which were subsequently determined to contain material U.S. GAAP errors.

IV. Key surety terms

There are some key terms that need to be understood when discussing the surety industry:

- **Principal** – The contractor; the party required to perform under the terms of the contract.
- **Obligee** – Usually the owner (however, may be the prime contractor when the bond is issued on behalf of a subcontractor); the party for whose benefit the bond is issued.
- **Indemnitor** – The party (or parties) responsible for repaying the surety for losses it has incurred.

V. Types of surety bonds

There are generally six types of bonds issued by the surety for the benefit of the construction industry. Three of those bonds are usually a concern for the accounting profession, while three others are usually not as much of a concern.

The three bonds that are usually a concern to the CPA profession are:

1. **Bid bond** – This bond is issued whereby the surety guarantees that if the contractor is ultimately awarded a particular contract, they will issue payment and performance bonds. The surety agrees to issue this type of bond only when it believes that the contractor is capable of fulfilling the terms of the contract. In addition, this type of bond is typically used by the owner to prequalify a contractor to bid on a particular contract.
2. **Payment bond** – This type of bond is issued whereby the surety guarantees payment for work already performed on that particular contract to subcontractors, material men, and suppliers. This bond provides assurance to the owner of the project that the project will be free of any liens resulting from unpaid subcontractors, material men, and suppliers. In accounting terms, this bond can be thought of as the contractor's accounts payable. This type of bond is also referred to as a labor and materials bond.
3. **Performance bond** – This type of bond is issued whereby the surety guarantees payment to subcontractors, material men, and suppliers for all work yet to be completed in order to fulfill the terms of the contract. In accounting terms, this bond can be thought of as the contractor's estimated costs to complete.

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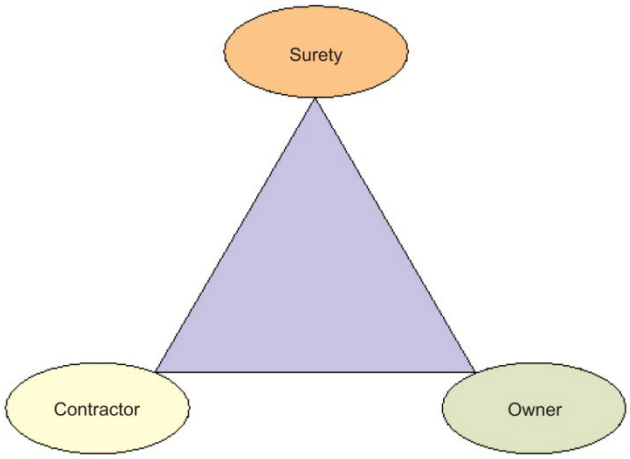
Accordingly, all obligations of the contractor (both incurred to date and those anticipated to be incurred) are covered by the surety by way of both the payment and performance bonds.

The three other bonds issued by the surety are:

1. **Completion bond** – In lieu of payment and performance bonds, the surety may issue a completion bond whereby the surety guarantees that the contractor will both perform and pay all bonded (contracted) obligations. In practice, this bond is rarely used by the surety industry.
2. **Maintenance bond** – This type of bond is issued whereby the surety guarantees against any faulty workmanship or material related to the contract. In most instances, this bond is effective for up to one year after completion of the project.
3. **Subcontractor bond** – A bond executed by a subcontractor and given to the general (prime) contractor to assure the subcontractor's performance on the subcontract, including the payment of all labor and materials required for the subcontract.

VI. The three-party relationship

In order for the construction industry to survive and flourish, there must be a relationship between three parties working in mutual cooperation. Below we see an illustration of the relationship between these three parties: the surety, the owner, and the contractor.



The **owner** agrees to pay the surety the price of the payment and performance bonds in order to give themselves a guarantee that the contractor will complete its bonded obligations.

The **surety** guarantees completion of the contract to the owner. If for any reason the contractor cannot complete its bonded obligations, the surety must then step into their shoes.

The **contractor** represents to the owner (by way of signing the contract) that it intends to complete all terms of the contract. In addition, the contractor promises to repay the surety any losses it may sustain should it incur costs and expenses required to complete its bond obligations (both payment bond and performance).

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VII. The bond agent

One of the most important components of the construction industry is the bond agent. The bond agent:

- Is an independent agency who has no connection to any individual surety.
- In fact, in most situations, the bond agent represents a number of sureties.
- Is considered the matchmaker of the construction industry. Their responsibility is to act as the intermediary between the contractor and the surety (who are both considered clients of the bond agent). In other words, they will attempt to match the contractor with the appropriate surety.
- In most instances, they will perform an analysis of the contractor's financial statements similar to that performed by the surety underwriter (which will be discussed in more detail later in this chapter) prior to the statements being forwarded to the surety underwriter.

If a contractor is seeking to obtain bond credit, it is critical that they obtain the services of a bond agent who, if needed, can act as an advocate for the contractor when negotiating with the surety. For the CPA practicing in public practice, it should be noted that bond agents are often a prime referral source of new business. If an agent has confidence in the integrity and technical ability demonstrated by the CPA firm, they will refer any contractor they represent who they feel is not properly serviced by their current CPA.

This will typically only occur when:

- The financial statements and related accountant's report are **timely** – if the agent and/or surety set a deadline for receipt of the accountant/auditor's report related to the contractor's financial statements, the CPA must meet that date (unless of course there are scope limitations or other situations that preclude the CPA from issuing their report).
- The financial statements are **accurate** (in other words, it is not subsequently discovered that the statements contained material misstatements in accordance with US GAAP.) There are few other circumstances that can strain a relationship between the bond agent and the surety than the agent submitting financial statements to the surety which resulted in a loss incurred by the surety.
- The financial statements are **informative**. In other words, they are prepared in a format acceptable to both the bond agent and to the surety.

VIII. Surety underwriting

Earlier it was noted that the role of the surety underwriter is to decide whether to extend bond credit to a potentially qualified contractor. In other words, they are the revenue producers of the surety.

In this section, we will discuss the underwriting process the surety utilizes when deciding whether to extend bond credit to a contractor.

In **theory**, when the surety issues a bond, it should never incur a loss. This is due to the fact that surety underwriting will usually obtain the following collateral against their bond exposure:

- Contract balances;
- Assets of the contractor entity; and
- Usually, a personal guarantee (indemnity) of the principal shareholders and/or officers.

Consequently, if those are the general conditions that are in place when the surety issues a bond, why do sureties ever incur losses?

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There are probably numerous reasons for this phenomenon, with the most prevalent being:

- Underwriters not following their company's underwriting standards (discussed next);
- Fraudulent collusion between the bond agent and/or the surety and the contractor; and
- Improper or fraudulent representation made by the contractor by way of many different venues. The most significant may be through improper financial reporting (possibly in collusion with the contractor's outside CPA).

So, how does surety underwriting work? Generally, surety underwriters will consider the three Cs:

- Character;
- Capacity; and
- Capital.

A. Character

Character is also known as integrity, honesty, and responsibility. Will the contractor do its due diligence in order to complete its bonded obligations? This assessment is purely subjective, and the underwriter will attempt to gather information concerning the contractor's character from numerous sources. These may include:

- The chief officers of the contractor itself;
- Key contractor personnel such as the project managers and estimators;
- Previous owners the contractor may have worked for;
- Subcontractors and suppliers who the contractor may have previously worked with; and
- The contractor's outside professionals (including, but not limited to the CPA, attorney, and banker).

B. Capacity

Capacity refers to the assessment of whether the contractor has the technical ability to complete its bonded obligations. Many underwriters are of the opinion that a contractor's past performance is the best indicator of its ability to perform future obligations. For instance, the surety may investigate if the contractor has historically completed its obligations on a timely basis or have there been delay issues with its owners. The surety will not only look exclusively at the contractor as a whole but will also look at individual units of the contractor when assessing capacity. Some of these units include:

- Estimating;
- Project management; and
- Field construction.

C. Capital

The surety will consider the question: Does the contractor have or possess the ability to access working capital in order for it to fulfill its bonded obligations?

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According to a survey of the surety industry, the following criteria are utilized when deciding who to provide bond credit to:

Criteria	Respondents
Strength of balance sheet	95%
Financial statement presentation	93%
Equity	87%
History of successful projects	81%
Debt	79%
Experience in type of project	78%
Consistent profit	77%
Use of CPA with industry knowledge	74%
Expertise of management team	72%
Claims history	67%
Reputation of firm	60%
Financial statement disclosure	60%
Accounting policies	55%
Experience in geographic area	55%
Size of under and overbillings	54%
Overhead expenses	37%
Contract volume	28%
Succession planning	28%
Safety record	14%
CFO has CCFP designation	3%

Although most of these items deal with the contractor's **capital**, many also deal with the other two **C**s: **character** and **capacity**.

It is also obvious from the above analysis that most sureties consider the quality, reputation, and expertise of the contractor's outside CPA when deciding which contractors will receive bond credit.

IX. Surety underwriters and contractor financial statements in a bond credit decision

Although there are many facets to the underwriting process, there is probably no other single document that the underwriter relies upon more than the contractor's financial statements audited or reviewed by the outside CPA.

What are some of the issues the underwriter will usually address?

- **Profitability** – The contractor will have to show that it is profitable in order to obtain bond credit.
- **Liquidity** – The contractor has to demonstrate that it has the ability to finance its current operations without the need for outside sources (sureties generally do not look favorably at outside sources, for example the bank, since these amounts will eventually have to be repaid and the surety is always concerned that these funds could come off their bonded jobs.

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- **Equity** – The surety will usually acknowledge that when a contractor is profitable and generating positive cash flow, the shareholders/partners are often entitled to distributions from the company. At the same time, if facts and circumstances dictate, the surety will usually expect these shareholders/partners to make additional capital contributions to the entity demonstrating their personal commitment to the continuance of the entity.
- **Overhead** – The surety always will be concerned when they view the contractor's overhead as excessive. In defining the term overhead for surety underwriting purposes, not only is the contractor's general and administrative expenses considered, but any cost or expense not job-costed is also taken into consideration. Included in this definition are non-job-related fixed asset purchases and principal payments on the entity's debt.
- **Officers' Compensation** – The surety underwriter understands that the contractor's officers need a reasonable wage for the services they are providing for the contractor. Where they may get concerned is when they perceive this amount to be excessive. Included in this definition of officer compensation is:
  (i) Payroll;
  (ii) Dividends and distributions; and
  (iii) Proceeds of shareholder loans.

As to the financial statements themselves, most surety underwriters will perform what is known as benchmarking; various ratio analyses where they compare financial results and financial positions of one contractor with other contractors. Based on those results (as well as many other factors), the underwriter would then make a bond credit decision.

Before the various ratios utilized by the underwriter are listed, it should be known that this analysis is not uniform for the entire surety industry. Procedures and analysis vary not only from surety to surety but may also differ between each individual surety field office.

Some of the more widely used ratios the surety underwriter will utilize are as follows.

A. Liquidity ratios

1. Current ratio

Current assets (as adjusted by the surety industry) to current liabilities; generally, the surety will want to see a ratio of greater than 1:1. In other words, a contractor's current assets (as adjusted) should be greater than their current liabilities.

2. Cash to equity

Generally, the surety industry will want to see a ratio greater than 20 percent.

3. Underbillings to equity

Large and growing underbillings are a concern to the surety because of uncertainty as to their eventual realization. Generally, the surety will not want to see this ratio greater than 20 percent.

4. Cash to overbillings

The surety industry will generally want to see a ratio greater than 1:1. Sureties get concerned when overbillings are greater than cash since this may indicate future cash flow issues for the contractor.

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B. Profitability ratios

1. Gross profit percentage

Gross profit percentage is one of the most important ratios. The surety will compare a particular contractor's results to similar contractors (industry averages). The surety will also look at the contractor's trends in recognizing gross profit for consistency.

2. Gross profit from the contractor's backlog to general and administrative expenses

The surety will want to know if the contractor's backlog (to be discussed later in this chapter) is sufficient to cover future non-job-related expenses (general and administrative expenses). Generally, the surety will want to see this ratio greater than 50 percent.

3. Net income as a percentage of revenue

The surety will compare a particular contractor's results to similar contractors (industry averages). The surety will also look at the contractor's trends for consistency.

C. Debt ratios

1. Total liabilities to net worth

The surety is concerned that the contractor's excessive liabilities may prevent it from completing its bonded obligations. In most instances, the surety will want to see a ratio of less than 3:1.

2. Interest-bearing debt to net worth

The surety will generally not want to see too much debt in relation to the contractor's net worth. In most instances, this ratio should not exceed 8:1.

D. Summary

A few concluding observations:

- A knowledgeable contractor (along with a competent outside CPA) may be able to explain away any ratio that does not meet the surety's criteria;
- One bad ratio by itself will usually not cause the surety to deny a contractor bond credit as most underwriters will look at an overall trend; and
- The surety will typically not look at an overall construction industry analysis – rather, it will consider the individual types of work the contractor performs (general contractor, subcontractor, construction manager, etc.).

X. How the surety analyzes the contractor's financial statements

In addition to the ratio analysis just discussed, the surety will often look at and analyze various components of the financial statements themselves when making a bond credit decision. Some of these considerations will now be presented.

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A. Cash

The surety will generally expect to see a healthy cash balance reflected in the financial statements as of the balance sheet date. There is no absolute amount concerning this factor, but it will not help the contractor to reflect total assets of millions of dollars and reported cash in only hundreds of dollars.

B. Contract receivables

Because the contractor's receivables often indicate future cash flow and its ability to be able to complete its bonded obligations, the surety will often closely analyze this account.

The contractor, along with their outside CPA, should be prepared to discuss the status of the entity's receivables – especially the reasonableness of the allowance for doubtful accounts reflected on the financial statements

C. Contract assets and contract liabilities

In theory, a contractor should never reflect contract assets and contract liabilities in their financial statements. The contractor should be able to bill for the exact amount of work they performed. However, in real life, this rarely happens.

Due to its direct relation to the contractor's job performance and related job cash flow, contract assets and contract liabilities are often one of the most important items that the surety will focus on when analyzing the contractor's financial statements.

1. Contract assets

When significant and growing contract assets are reflected in the contractor's financial statements, it may become a concern to the surety. The surety's concern is that these contract assets may actually be:

- Unapproved change orders buried in this asset rather than being properly shown as a receivable as required by U.S. GAAP;
- Unrealized claims buried in this asset rather than being properly shown as a receivable as required by U.S. GAAP; and
- Additional costs incurred by the contractor which should have been shown as a job expense during the reporting period (a possible indication of inadequate estimating abilities demonstrated by the contractor).

There are, however, situations when a contractor may experience true contract assets. For example, the contract requires the contractor to purchase equipment or materials at the beginning of the contract but does not allow the contractor to install the equipment or utilize the materials on the job, and accordingly, the contractor cannot bill the owner for these particular costs. This is known in the construction industry as uninstalled materials. If these uninstalled materials become significant, it could create numerous problems for the contractor, including:

- Cash flow problems since the contractor will have to pay for the uninstalled materials at an earlier date than when it will receive repayment of the cost through billing of the owner;
- Possible interest expense incurred related to fronting the cash to purchase these uninstalled materials;
- Storage costs; and
- Insurance expense.

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Note that this is one of the many reasons the contractor should be represented by an attorney with specific expertise in the areas of construction and contracts. If the uninstalled materials issue becomes a problem for the contractor, it may want to consider rewording the terms of the contract to allow for earlier billing of these uninstalled materials.

It should also be noted that for financial statement reporting purposes, uninstalled materials should be considered the contractor's inventory and should not be used in the revenue calculation as either the numerator (costs incurred to date) or the denominator (total estimated contract costs).

The contractor and its outside CPA should be prepared to discuss the legitimacy of reported contract assets to the surety.

2. Contract liabilities

At first glance, this account should not be a concern since in the eyes of the surety, the owner is willing to pay the contractor for work not yet performed. The surety will generally become concerned when the contractor's cash balance is less than the amount of contract liabilities. This may be an indication that the contract liabilities were spent by the contractor and in the future, it may incur cash flow difficulties as the job moves towards completion.

The contractor should attempt to manage their cash balance in order to present their cash balance greater than the reported contract liabilities as of the balance sheet date. If in fact contract liabilities are greater than the cash balance, the contractor and its outside CPA will need to provide the surety with some type of assurance that the particular job, as well as the entity as a whole, will not experience future cash flow difficulties.

As a final note concerning contract assets and contract liabilities, the contractor should almost never be what is considered net underbilled. This term means that contract assets should generally not exceed contract liabilities as of the reporting date. If the contractor finds itself in this situation, it could be an indication of:

- Billing issues (the contractor may not be billing the owner on a timely basis);
- Estimating issues (there could be problems when the contractor is calculating its estimated costs to complete on jobs in progress; and
- Uninstalled materials (as was previously discussed).

The fact that the contractor reports net contract assets may be a concern to the surety requiring an explanation of the fact by management along with the outside CPA.

D. Property, plant, and equipment

The category property, plant, and equipment is often a problematic area for the contractor and often a major concern of the surety.

- **Too much equipment** – The surety may be aware that the contractor owns more equipment than may be needed to complete its bonded obligations. This could be an indication of excessive overhead costs related to idle equipment.
- **Too little equipment** – Because of a shortage of this critical component needed by the contractor, the surety may take the position that the contractor is not in a position to be able to complete its bonded obligations.

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The contractor (in addition to its outside CPA) should be able to defend the amount of fixed assets owned by the entity.

E. Contract payables

Similar to contract receivables, the surety will consider the components and status of the contractor's payables. The underwriter will also consider the spread between the contractor's receivables and payables. Payables greater than receivables could be an indication of future cash-flow problems.

F. Debt

Any of the contractor's debt owed to third parties (for example, the bank or other asset-based lenders) is a concern to the surety. In particular, this concern often centers on the current portion of the debt (including lines of credit and balloon payments due on the long-term debt). The contractor and its outside CPA will need to explain why future debt payments will not impact the contractor's ability to complete its bonded obligations.

G. Job schedules

The three job schedules (detailed in Chapter 3) are probably the single most important component of the contractor's financial statements the surety will focus on when making a bond credit decision.

When analyzing these job schedules, the surety will concern itself with a number of considerations. Probably the most important being if there are any indications of profit fade recognized by the contractor (to be discussed next).

H. Profit fade

Profit fade (otherwise known as slippage) is often a warning sign to the surety of possible financial difficulties involving the contractor.

What is profit fade? It is defined as a decrease in recognized gross profit off of original estimates. Usually, the surety will look at a decrease of 10 percent off of original estimates as the red flag.

Example: Eskin Construction originally estimated that job 101 would recognize gross profit in the amount of $100,000. However, when competed, the job recognized gross profit of $80,000. Since the job recognized profit fade of greater than 10 percent (this job recognized slippage of 20 percent), it would be a concern to the surety. It should be noted that in most instances, one job will not necessarily be a concern. However, if the surety sees a pattern of significant profit fade, that would be considered the red flag.

I. Job borrow

When overbillings become too much of a problem for the contractor, this is known as job borrow. Job borrow may create a situation where the contractor gets so far ahead in billing on a job that it will have to find other sources (borrowing from the bank, contract balances from other jobs, cash-on-hand) to complete this particular job. This obviously becomes an issue for the surety in deciding whether to provide additional bonding for this contractor.

The formula for job borrow is:

Job borrow = Overbillings – Total estimated profit on the job

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J. Income statement

In addition to reflecting on the contractor's ability to generate a net income, the surety will often concentrate on two other items from the income statement:

- Gross profit; and
- General and administrative expenses; both as a percentage of earned revenues and in addition to its individual components (such as officer compensation).

K. Statement of cash flows

Even though a statement of cash flows is required under U.S. GAAP, many underwriters will generally not rely upon this statement when making a credit decision.

However, this statement should be able to provide the surety with valuable information such as:

- If the statement reflects a negative cash flow from operating activities, the surety will want to know how the contractor will be able to pay its operating expenses in the future; and
- Similar to other types of entities, regarding the contractor, if the statement reflects a large positive cash flow from financing and/or investing activities, it may become evident to the surety that the contractor is financing its operations through selling assets (investing activities) or through borrowing from the bank or other third parties (financing activities).

L. Contingent liabilities

When underwriting an account, the surety will not only consider issues on the balance sheet; they are equally concerned about issues off the balance sheet. In other words, they want the entire picture.

M. Backlog

Many sureties consider the contractor's backlog to be one of the more important disclosures in their financial statements.

Whereas most numbers on the financial statement are old and historic (most information is anywhere from three to 15 months old by the time the surety receives the financial statements), backlog is the only forward-looking information that informs the surety where the contractor may be heading in the future.

Note that backlog was discussed in greater detail in Chapter 3.

N. Going concern

When the surety requires that contractor financial statements be audited or reviewed by the outside CPA, one of their principal concerns is whether the CPA concluded it was necessary to include a going concern disclosure. Most sureties will deny any bond credit to a contractor if the going concern is in fact included in the accountant/auditor's report.

Note:

The issue of going concern was discussed in more detail in Chapter 3 dealing with its financial statement disclosure.

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XI. How the contractor can maximize bonding capacity with the surety

There are three parties who have a vested interest in maximizing bond credit:

- **The surety** – The ability to issue bonds is its principal source of recognizing revenue;
- **The bond agent** – The more credit issued by the surety, the greater commissions they will earn; and
- **The contractor** – The more bond credit they receive from the surety, the more jobs they can bid on and perform (if they are eventually awarded the contract).

So how can surety credit be maximized? It must be noted that not only does the criteria very from surety to surety, but it could also very from local office to local office. Generally, the rule of thumb is that the surety will provide bond credit based on the following two criteria:

- The maximum credit the surety will provide for a single job is 10 times the contractor's working capital (as defined by the surety); and
- The maximum credit the surety will provide for a contractor's entire job program is 10 times its net worth.

In regard to working capital, it should be noted that this definition is not in accordance with that used for U.S. GAAP purposes, but that defined by the surety industry, as will now be demonstrated:

- The surety will start with current assets as defined by U.S. GAAP.
- They will then subtract the following assets:
  - (i) Any contract receivable greater than 60 days old.
  - (ii) Any receivable due from an employee.
  - (iii) Any receivable due from a related party (shareholder/partner, officer, or any other entity related to the contractor).
  - (iv) Any note receivable where the surety is unsure as to its collectability.
  - (v) 50 percent of any inventory not located at the jobsite.
  - (vi) All prepaid expenses.
  - (vii) Any other current asset that will not result in future cash flow for the contractor.
- They will then add the cash surrender value of officer's life insurance (shown as a long-term asset for U.S. GAAP reporting purposes).
- In regard to the contractor's liabilities, the surety will accept the amount as reported for U.S. GAAP reporting purposes.

These four items are all netted together to derive the amount of bond credit the surety will provide the contractor on a single job.

XII. Warning signs of contractor failure

When the surety provides a contractor with bond credit, it will often monitor the progress of the bonded job in addition to the contractor as a whole. This usually will be done by:

- Periodic visits by the underwriter to the contractor's office and/or the bonded jobsites;
- Monthly financial information prepared by the contractor; and
- Annual/quarterly financial statements prepared by the contractor and audited or reviewed by the outside CPA.

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The surety will be looking for warning signs that the contractor may be currently experiencing or in the future may experience financial difficulties. The expectation is that these warning signs will be uncovered by the surety early enough so to allow the surety to limit or eliminate any potential loss they may incur.

Some examples of these early warning signs include the following:

- Significant and ever-growing contract assets.
- Large contract liabilities without a corresponding amount of cash in the bank.
- A significant increase of third-party financing (e.g., a line of credit received from a bank).
- An ever-growing overhead.
- A decrease in the contractor's backlog without a corresponding decrease in their overhead.
- Significant profit fade resulting from one or both of the following situations:
  - (i) From how the job was originally estimated to actual gross profit recognized when the job was completed; and/or
  - (ii) For a long-term job, the difference between estimated gross profit when the job was still in progress at the balance sheet date to how much gross profit was recognized when the job was completed.
- An increase in the frequency of payment bond claims filed by suppliers, material men, and subcontractors.
- Negative cash flows from operating activities from the statement of cash flows.
- Unreasonable officer compensation (includes salaries, distributions, and proceeds from loans). From the perspective of the surety, excess compensation could be an indication that management is not committed to the long-term financial stability of the entity.

XIII. How the surety deals with a bonded contractor experiencing financial difficulties

Despite even the most stringent underwriting standards, a contractor bonded by the surety may experience financial difficulties that potentially could preclude it from completing its bonded obligations. What could be the cause of these financial difficulties? Here are just a few of those reasons:

- Poor estimating demonstrated by the contractor when originally bidding on the job.
- Issues involving the original plans and specifications when biding on the job.
- Unexpected increase in price for materials and supplies during the construction period.
- Unexpected shortages of supplies and materials needed for job performance.
- Unexpected problems with the contractor's current subcontractors.
- The inability to find additional contractors while the job is in progress.
- Labor issues (for instance, a strike by its employees).
- Inefficiencies demonstrated by the contractor during the construction period.
- Unexpected environmental issues.
- Weather delays.
- Issues with the contractor itself, including:
  - (i) Changes in personnel, especially at the senior management and project management positions;
  - (ii) Financial and other difficulties impacting the contractor such as the inability to obtain future bonding or third-party financing such as a line of credit; and
  - (iii) Financial and other difficulties impacting the key officers, shareholders, and senior management of the entity.

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If a contractor determines that it is experiencing financial difficulties, the following is the order of obtaining financing management should consider in order to allow them to complete their bonded obligations:

1. **Sources from within the entity** – The surety would want (and expect) the contractor to fund their financial difficulties by way of their own assets and operations. For example, reducing their overhead or selling assets that are no longer needed.
2. **Equity contributions** – The surety will generally understand that in profitable years, the shareholders/partners may distribute those profits to themselves. At the same time, when the entity is experiencing financial defaulters, these same partners/shareholders would be expected to address the situation by contributing equity back into the entity.
3. **Partner/shareholder loans** – If the partners/shareholders cannot (or do not) want to make capital contributions to the entity, the next best measure would be for them to make loans. This is less preferable to the surety since the proceeds of the loans impact the entity's liabilities while the contributions impact the equity section of the balance sheet. In addition, the surety would want these loans subordinated to their interest which would generally prohibit repayment of the loan without the surety's approval.
4. **Third-party loans** – Loans from outside sources (typically a bank) are a concern to the surety since the loan will eventually have to be repaid. The surety's principal concern is that contract funds could come off boned projects in order to repay these loans.
5. **The surety** – As a last resort, the contractor may want to go to the surety for financial assistance (but this option should be considered only if there are no other options open to the contractor). The contractor's major concern of going to the surety is that the potential of receiving future bonding decreases significantly once the surety receives this request.

Once the surety has identified a troubled contractor, it now has to determine how to deal with the situation. In other words, what can the surety do?

Should the surety provide financial and other assistance to their principal or should it allow the contractor to continue to struggle and eventually be terminated off the job by the owner which will then provide the surety the opportunity to bring another contractor of its choosing in order to complete its bonded obligations?

There are two options available to the surety:

- The finance option; and
- The relet option.

A. The finance option

The surety provides the financial support needed by its principal (the contractor) in order to allow both parties to complete their bonded obligations.

1. Advantages

The surety may be able to reduce its potential loss by not incurring the expense of finding and bringing in a completion contractor who may charge more than what would have been paid to the original contractor. The surety may also be able to keep an existing customer in business, which may result in future revenue for the surety. It may be desired by the owner to keep the original contractor in place rather than bring in another contractor.

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2. Disadvantages

The surety's loss is open ended. Whereas the surety's liability is generally capped at the bond amount (known as bond penalty), if the surety elects to utilize the financing option, their potential loss could exceed this bond penalty amount.

Time and expenses are incurred monitoring its principal. In other words, if the surety elects to provide financing, it will not give the contractor a blank check, but will closely monitor its principal to assure the funds are used for bond completion and not for other purposes.

B. The relet option

The surety declines to provide financial support to its principal, waits for the contractor to be defaulted (terminated) by the owner, and then brings in another (completion) contractor of its choice in order to fulfill its bonded obligations.

1. Advantages

The surety can cap its loss. Once the agreement is signed with the completing contractor, the surety has no further obligation under the bond (unless the completing contractor is not able to perform as per the agreement).

There are no monitoring times and expenses that would have to be incurred by the surety.

2. Disadvantages

This option may result in more cost to the surety since the completing contractor will usually charge more than what would have been incurred with the original contractor. Since there may be delays involving the removal of the original contractor and the mobilization time involving the completing, liquidated damages and other costs may be charged against the contract.

The completing contractor may not be acceptable to the owner, which could strain relations between the owner and the surety. If the original contractor is allowed to be terminated and eventually ceases operations, the surety may be losing a good customer.

C. Summary

What are the factors that influence whether a surety will finance its troubled principal or relet the job to a completing contractor?

In many instances, when the surety receives a financing request from its principal, it will perform an investigation performed by three parties:

- An engineer who will consider various job performance issues;
- A CPA/accountant who will consider various financial issues; and
- An attorney who will lead the investigation.

The surety will usually address two specific matters:

- Contract issues; and
- Business issues.

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XIV. Contract issues

Contract issues are those related to job performance. The engineer will usually consider the following:

- **The job's projected completion date** – The longer time expected to be needed for job completion, the greater the possibility the surety will relet the job and the reduced possibility that the surety will finance its principal.
- **Is the job self-performed by the contractor or does it utilize sub-contractors** – There is a greater possibility that the surety will finance the job if it is self-performed since it may be more beneficial to have the same people manage its own workers rather than bring in a party unknown to the workers.
- **The quality of the contractor's work performed to date** – The surety may be more inclined to finance the contractor if their work is of a high quality and more inclined to relet the job if the work is not considered satisfactory.
- **Estimated costs to complete** – If the estimated costs to complete the job are considered insignificant, there is a greater chance that the surety will finance the contractor. On the other hand, if the estimated costs are considered significant, the surety may be more inclined to relet the job.
- **Type of work** – The surety would be more inclined to finance its principal if the work is more specialized – indicating that there may not be many completing contractors available (for example, electrical work). On the other hand, if it is expected that numerous contractors would be available (since the work is not considered specialized; for example, road building), the surety may be more inclined to relet the job.
- **Availability of completing contractors** – The surety's decision will be impacted by the current state of the construction industry. When the industry is strong, there may not be many contractors available for the relet option. When the economy is weak, there may be more completing contractors available.
- **The principal's relationship with the owner** – It is more likely that the surety will finance the contractor if they have a good relationship with the owner, and conversely, if the contractor has a poor relationship with the owner, the surety may be more apt to relet the job.
- **The principal's relationship with its subcontractors and suppliers** – It will usually be more difficult for the surety to relet the job if this decision may result in difficulties with the various subcontractors and suppliers which could result in additional costs and eventually losses to the surety. Conversely, if these relationships do not impact job progress, the surety may decide to go with the financing option.
- **Status of contract funds** – There may be occasions where the contractor's relationship with the owner may assist in the release of contract balances. In these situations, the surety may be more inclined to utilize the financing option.

XV. Business issues

Business issues are those related to financial and other related concerns. The CPA/accountant will often consider the following factors:

- **The current financial condition of the contractor** – The surety may be more inclined to finance a contractor who is financially healthy since there is a greater probability that its bonded obligations will be completed on a timely and cost-economical basis.
- **The projected financial position of the contractor** – The surety will not only consider the contractor's current financial situation but will also attempt to determine the

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contractor's financial situation during the entire proposed financing period since future contractor difficulties could impede completion of the surety's bonded obligations.

- **Management's short-term and long-term intentions** – The surety may be more inclined to provide financing to a contractor who is in the game for both the short-term as well as for the long-term since this type of contractor is more inclined to do their due diligence in completing bonded obligations on a timely basis since they may want to obtain future bond credit.
- **The financial position of the contractor's chief officers and shareholders** – The surety will be more inclined to provide financing if the owners and directors of its principal are considered strong and stable.
- **The ability of the contractor and its chief officers and shareholders to secure additional collateral** – When the surety originally issues its bond, it will usually obtain a blanket lien on both the entity and chief officer and shareholder's assets. If the principal officers and shareholders can provide additional collateral, the surety may be more inclined to provide financing. This additional collateral will be looked at by the surety as sources of cash to repay them for any loss they may incur.
- **Overhead** – For purposes of this analysis, the surety will not only consider the contractor's general and administrative expenses, but any other cost or expense that is not generally job costed. These would usually include the following. The surety generally will only finance the costs of completing its bonded obligations, not costs and expenses not related to job completion (overhead) unless the surety determines that financing these items will enhance job completion.
  (i) Computers and other office equipment used for non-job-related purposes;
  (ii) Automobiles purchased by the entity and used by non-job-related officers and employees; and
  (iii) Interest and principal payments on non-job-related debt.
- **Ability to obtain nonbonded work** – A contractor who is able to obtain work not bonded by the surety may be looked at more favorably by the surety for possible financing since any profits generated from this unbonded work may be able to pay for the contractor's overhead.
- **Current financial status of the nonbonded work** – If the contractor is able to obtain nonbonded work, the surety will need to determine if these jobs are in fact profitable and generating positive cash flow. Without this cash flow, then these jobs will not help pay for the contractor's overhead and the surety will be less likely to finance its principal since they generally do not want to pay these expenses; only those directly or indirectly related to completion of its bonded obligations.
- **Union obligations** – In most instances, the surety will be reluctant to provide financing to a contractor who is in arrears with their union obligations since this may be an indication of future labor issues which may preclude completion of the bonded obligations. In addition, the union may be able to cause the owner to withhold payment of contract balances owed to the surety.
- **Payroll tax obligations** – Even more of an issue to the surety than union obligations is the situation when the contractor is behind with its various payroll tax obligations. In particular, nonremittance of amounts withheld from employees (particularly involving federal, but also includes state and local withholding) are the greatest concern since in most circumstances, these taxing authorities may have a superior position on the

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contract balances, ahead of the surety (who in most cases will be ahead of all other creditors).

- **The principal's relationship with its bank and other lending institutions** – The surety will be more inclined to provide financing to its principal if the contractor has a strong and ongoing relationship with its bank as well as other lending institutions. In most instances, if these relationships are deteriorating, the surety will be more inclined to utilize the relet option since it does not want to appear to be accepting the risk with this contractor that the bank and other lenders are vacating.
- **Contingencies** – When considering contingent liabilities and the contractor, there are three factors that are often of the greatest concern to the surety. It is obvious that the surety will be much less inclined to provide financing to its troubled principal if these (as well as any other) contingencies exist since they may impede completion of the surety's bonded obligations and could ultimately cost the surety additional losses in order to satisfy these liabilities.
  (i) Ongoing and pending lawsuits;
  (ii) Ongoing and pending Internal Revenue Service and other taxing authority examinations; and
  (iii) Environmental issues.
- **Quality of the contractor's internal financial reporting** – When the surety finances a contractor, it does not give them a blank check, but it will closely monitor job and financial performance. Obviously, the surety will be more inclined to finance a contractor who is able to provide the surety with timely and accurate financial information.
- **Quality of the contractor's outside CPA** – Since in many instances the surety will rely upon the outside CPA for various financial information, it may be more inclined to utilize the financing option if it has a higher level of assurance that the CPA will be honest and objective in its dealings with the surety, especially in the area of providing timely and accurate information the surety may need to utilize when monitoring its principal.
- **Integrity** – In many instances, this may be the overriding factor the surety will consider in its financing decision. It should be noted that even if a contractor demonstrates integrity, it will not automatically result in receiving financing from the surety. But lacking integrity will almost certainly result in the surety utilizing the relet option. When discussing integrity, included in this definition are the following:
  (i) Any cash advanced by the surety to the contractor will be used solely as intended by the surety (completion of the bonded obligations) and not for any other purpose (such as financing the contractor's overhead or other, nonbonded jobs).
  (ii) The contractor will do its utmost due diligence to complete its bonded obligation as quickly and efficiently as possible performing only quality work.
  (iii) The contractor will be honest and diligent in reporting to the surety any job-related problems.
  (iv) The contractor will timely and accurately report to the surety as part of its monitoring items such as:
    - The proper verification of any cash received from either from the surety or from the owner; and
    - The utilization of the cash for only bonded job completion purposes and not for overhead or nonbonded jobs (unless allowed for in the financing agreement).

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XVI. Summary

In summary, it should be noted that in most instances, the surety will not simply rely on a few of the contract and business issues detailed above. It will usually consider all of the items, putting emphasis on those which are of the highest concern to them. How often will a surety provide financing to its troubled principal? There is no straight answer as the financing vs. relet decision may vary not only from surety to surety, but also from management team to management team within the surety. However, it has been estimated that the surety will finance its troubled principal less than 10 percent of the time.

What may ultimately impact the surety's decision?

- The economy;
- Its willingness to gamble on its principal since the financing option may result in a significantly larger loss (as compared to the relet option);
- The amount of additional assets the principal can offer as collateral; and
- Its past experience in utilizing the financing option.

XVII. What's in it for the contractor?

What is at stake for the contractor in connection with the surety's financing vs. relet decision? Should the surety elect to relet:

- There is a distinct probability that the contractor may have to cease operations. This is due to the fact that the surety industry (both the existing surety and any future, potential sureties) will probably no longer provide any additional bond credit.
- If in fact the surety has already incurred a loss, since they will not have any future business relationship with their principal, they may institute policies to recover from their principal for these losses, including:
  (i) Immediately attempting to collect on their collateral; and
  (ii) Seeking indemnity from the corporate and personal guarantors, including instituting legal action against one or both parties.
- The contractor may find difficulty in obtaining even nonbonded work since their reputation as a qualified contractor will have been damaged.
- There is a strong possibility that other creditors (bank, vendors, subcontractors, etc.) will also initiate steps to reduce their losses.

  It should be noted that the contractor will not have any obligation to complete the contract on which they have been performing (due to the fact that when the surety relets a job, it will release its original principal from all responsibility related to completing the job).

Note:

At the same time, the contractor may find it judicious to closely monitor the job performance by the completing contractor in order to mitigate any additional loss the surety may incur for which may be the responsibility of the contractor.

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If the surety elects to finance:

- If the contractor can successfully fulfill its bonded obligations as a result of receiving financial assistance from the surety, they may be eligible for future bonding from their current surety or possibly another surety.
- If the surety only provides financing related to job performance related to its bonded obligations, the contractor will need to find an alternate source of financing to pay for its overhead and nonbonded jobs.
- The contractor will have to go through recurring monitoring (financial monitoring, job performance monitoring, or both) from the time of financing until completion of the job. This may involve:
  (i) Joint funds control whereby a bank account is established by the surety. All bonded contract balances received as well as the proceeds from loans made by the surety are deposited into this account, and any disbursement from this account requires the approval (signature) of both the contractor and the surety.
  (ii) A periodic (or constant depending on the amount of exposure and complexity of the job) engineering and/or accounting presence by the surety.

VIII. The role of the outside CPA

The role of the outside CPA cannot be overemphasized when discussing this critical decision the surety will have to make regarding the troubled contractor. Many sureties will not even consider the financing option if they do not have confidence in the integrity and objectivity of the contractor's outside CPA. Some of the areas the outside CPA can assist both the surety and their client (the contractor) includes:

- Assisting their client in identifying sources of additional collateral they may be able to provide the surety.
- Assisting their client in producing the financial information the surety may seek involving their monitoring function during the financing period (schedule of cash receipts, schedule of cash disbursements, job production related schedules, bank reconciliations, etc.).
- Assisting their client in producing periodic financial statements as required by the surety and other users of the financial statements (usually required on a monthly basis).
- Assisting the surety with their physical monitoring of the contractor (this will only happen if the outside CPA truly demonstrates that they are objective and unbiased regarding their client and the surety).
- Assisting the client in preparing and filing all required tax returns (income, payroll, etc.).\
- Assisting their client in developing a realistic repayment plan to the surety.
- Regarding the annual/six month/quarterly financial statements themselves where the surety may require the performance of some type of attestation function, the outside CPA should (when feasible) take responsibility in their audit/or accountant's report for not only the financial statements themselves, but also the supplementary information (as discussed in Chapter 3). Many sureties will not even consider extending bond credit or give much credence to a contractor if their outside CPA disclaims or does not take any responsibility for the critical financial information (especially the supplementary job-related schedules).

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Important Taxation Issues Impacting the Construction Industry

Learning objectives

Upon reviewing this material, the reader will be able to:

- Identify key tax issues impacting the construction industry;
- Recognize sections of the Internal Revenue Code (IRC) impacting the construction industry;
- State who qualifies for the small contractor exemption and the advantages it presents the contractor;
- Recall the different methods of income recognition from long-term contracts available when a contractor qualifies for the small contractor exemption;
- Recognize the advantages to the taxpayer of the 10 percent deferral election;
- Identify the major differences regarding cost capitalization rules between U.S. GAAP and the Internal Revenue Code;
- Recognize how the alternative minimum tax (AMT) impacts the construction industry;
- State the issues involved with the look-back provisions;
- Identify the key tax provisions impacting homebuilding contracts;
- Identify the key tax provisions impacting residential construction contracts;
- Recognize the impact of misclassification of employees and independent contractors; and
- State the key provisions of FIN 48 and how it specifically impacts the construction industry.

I. Introduction

In this, the last chapter, we will discuss some of the most important practical issues associated with taxation related to the construction industry. We will also discuss how the provisions of the Internal Revenue Code (used for income tax preparation) differs from U.S. GAAP (used for financial statement preparation).

Similar to issues involving U.S. GAAP, many CPAs consider the rules of taxation for contractors to be among the most difficult compliance requirements (especially in comparison to other lines of business). The construction industry has many tax issues, some of which are shared with other industries, and some of which are unique to contractors. This chapter will concentrate on those issues unique to the construction industry, which includes those changes originally brought about by the Tax Cuts and Jobs Act of 2017 and then modified later by the One Big Beautiful Bill Act of 2025. We will also discuss how recent changes have affected the Inflation Reduction Act provisions.

II. Key tax issues involving the contractor

There are two tax issues impacting the construction industry that will now be discussed:

a. Methods of recognizing revenue from long-term contracts; and
b. Cost capitalization rules.

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III. Taxation of long-term contracts

The authoritative source for taxation of long-term contracts is §460. This section generally provides for the use of the percentage-of-completion method for recognizing revenue from long-term contracts with some exceptions (which will be discussed shortly).

What is a long-term contract as defined by §460? "[A]ny contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into."

Furthermore, this section notes that in addition to the long-term provision, a contract must be a construction (as opposed to a manufacturing) contract in order to fall under this section.

What is a construction contract as defined by the IRC? "[A]ny contract for the building, construction, rehabilitation of, or the installation of any integral component to or improvement of real property."

Section 460 provides the following examples of the term real property:

a. Buildings;
b. Dams;
c. Roads; and
d. Similar property (i.e., this list is not all-encompassing).

There are three types of construction activities and one type of contractor that are generally exempt from the provisions of §460:

a. Home construction contracts (§460(e)(1)(A));
b. Residential construction contracts (§460(e)(4)); and
c. Certain other specifically exempt activities.

In addition to these three activities, those contractors who qualify for the small contractor exemption are also exempt from §460.

If an activity or type of contract is exempt from the provisions of §460, it means that the normal percentage of completion method does not automatically have to be used. This generally leaves open the ability to use other methods of accounting (cash, accrual, completed contract, etc.).

A. Home construction contracts

According to §460(e)(1)(A), home construction contracts are granted a special exemption from the requirement to use the percentage-of-completion method.

What is a home construction contract? A home construction contract is any construction contract where 80 percent or more of the estimated total contract costs, as of the close of the tax year in which the contract was entered into, are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of: (1) dwelling units contained in buildings containing four or fewer dwelling units (with each townhouse or row house treated as a separate building); and (2) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.[1] It

[1] Section 460(e)(5); Treas. Regs. §1.460-3(b)(2).

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should be noted that for the purposes of this definition, each townhouse or row house should be treated as a separate building.

It should also be noted for purposes of the 80 percent test, the costs of offsite work are treated as contributable to the construction of the house. The definition of offsite work includes:

a. Sidewalks;
b. Roads;
c. Sewers; and
d. Other common features not located on the site of the dwelling.

The definition just noted applies to the general (prime) homebuilding contractor. The question then raised is, are the subcontractors working on the same homebuilding project also exempt from §460?

The answer appears to be yes. Although the U.S. Department of the Treasury has not specifically commented on this issue, the CPA profession has generally accepted the position of exempting subcontractors, similar to the exemption provided to the general homebuilder.

Accordingly, contractors (both general contractors and subcontractors) who perform both commercial work (subject to §460) and homebuilding work (exempt from §460) must be able to segregate revenues earned and costs incurred between the two lines of business to potentially reduce the associated tax liability for the current year.

B. Residential construction

In addition to homebuilding, the OBBBA added residential construction as exempt from the requirement to use the percentage-of-completion method.[2] Residential construction contracts are defined as contracts other than home construction contracts for which 80 percent or more of the total estimated costs under the contract are reasonably expected to be attributed to the building, construction, reconstruction, or rehabilitation of, or improvements to, real estate directly related to and located on the site of dwelling units, as defined by §168(e)(2)(A)(ii).[3]

Examples of residential contracts include:

a. Apartments;
b. Dormitories;
c. Barracks;
d. Prisons; and
e. Nursing homes.

Residential construction is taxed as follows:

a. Revenue recognition – Required to use a special method of recognizing revenues from their long-term contracts known as the 70/30 percentage-of-completion/capitalized-cost method. Under this method, 70 percent of the contract is reported on the percentage-of-completion method, while for the remaining 30 percent, the contractor may utilize their normal method.

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[2] Section 460(e)(1)(A), effective July 4, 2025. It should be noted that this was also generally true under TAMRA '88 for periods prior to this.

[3] Section 460(e)(4) and (e)(5)(B); Treas. Regs. §1.460-3(c).

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b. What is the normal method? It may be:
   (i) The completed-contract method;
   (ii) The cash method (subject to the restrictions detailed later in this chapter); or
   (iii) The accrual method.

Important: For all contracts entered into in tax years beginning after July 4, 2025, large contractors are no longer required to use the percentage of completion method or the 70/30 method. In other words, the normal method of accounting would generally be available, including the completed-contract method.

a. Cost capitalization – The rules of §460 apply.
b. Alternative minimum tax (AMT) – Must be calculated using the 100 percent percentage-of-completion method. No alternative minimum tax adjustment is required for any residential construction contract entered into in a tax year beginning after July 4, 2025.

C. Specifically exempt construction activities

As the result of various revenue rulings issued by the IRS, the following four construction related activities are specifically exempt from §460:

a. Industrial and commercial painters;
b. Engineers;
c. Architects; and
d. Construction management services.

If a contractor is engaged in both exempt (for example, painting) and nonexempt (for example, roadbuilding) activities, they must be able to segregate revenues earned and costs incurred between the two lines of business in order to potentially reduce their associated tax liability for the current year.

D. Small contractor exemption

Many of the contractors that CPAs work for or represent will be exempt from the provisions of §460 because they qualify for the small contractor exemption. Why would a contractor want to be eligible for this exemption? Because they would be entitled to utilize other methods of recognizing revenue from long-term contracts which may allow them to defer the recognition of taxable income.

How can a contractor be eligible for the small contractor exemption? Only if they meet all three of the following conditions:

a. The contracts must be considered construction contracts, not manufacturing contracts, as the latter is not eligible for the small contractor exemption;
b. The contract cannot last longer than two years (as originally estimated by the contractor); and
c. The contractor's average annual gross receipts for the three taxable years preceding the current taxable year, in which the contract is entered into, cannot exceed $25 million ($32 million for tax year 2026).

It should be noted that this exemption is applied on a contract-by-contract basis. In other words, the same taxpayer may have some contracts required to use the percentage-of-completion method and others that are not.

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1. Construction contracts

The first requirement deals with the type of work performed by the contractor. The basic difference between a construction contract and a manufacturing contract is that the former deals with real property while the latter deals with personal property. Only construction contracts qualify to be exempt.

2. Two-year completion test rule

This second requirement to make a contractor eligible for the small contractor exemption requires that a contract be completed within two years from when it started.

a. **Start date** – When the contractor first incurs any allocable costs other than costs attributable to bidding the contract.
b. **Completion date** – When the contract would be completed under the definition of the completed-contract method. Basically, this occurs when the customer uses the subject matter of the contract and at least 95 percent of the expected total contract costs have been incurred, or final completion and acceptance of the subject matter of the contract.

The test is applied when the contract is entered into. It is strictly an estimate, and the burden of proof is on the contractor to be able to document how long it will take to complete the project. Again, it should be understood that this issue applies to individual contracts, not to the contractor as a whole. If any contract fails the two-year test, it is not eligible for the small contractor exemption and must use the percentage-of-completion method. Therefore, a contractor may find that in a given year, some of its contracts may have to be accounted for using the percentage-of-completion method while others will be exempt.

Note:

Once the contractor makes a determination concerning the two-year test for an individual contract, they must continue to use the method chosen at the beginning of the contract even if facts and circumstances change while the job is in progress. In other words, they are not required to change their method while the job is in progress.

3. $25 million gross receipts test

The third requirement to make a contractor eligible for the small contractor exemption involves the requirement that their annual gross receipts do not exceed $25 million ($32 million for 2026). There are two key issues that must be considered:

a. The definition of gross receipts (for purposes of applying the test); and
b. How to apply the test.

What should be included in gross receipts? §448 mandates all receipts (with some exceptions as detailed next) from the active conduct of all trades or businesses, including related entities, must be included. Accordingly, the definition of gross receipts is not limited to construction-related activities.

What gross receipts are excluded?

a. Sales returns;
b. Sales allowances;
c. Interest, dividends, and rents received that are not in the ordinary course of business;
d. Proceeds from loans made to the contractor and loan repayments from loans made by the contractor;
e. Receipts from a sale not in the ordinary course of business; and
f. Proceeds realized from the sale of capital assets.

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In addition to gross receipts from all of the contractor's businesses, a proportionate share of construction-related gross receipts from any person owning a 5 percent or greater interest in the contractor, or in which the contractor owns a five percent or greater interest must be included in the contractor's gross receipts. All ownership interests should be determined as of the first day of the contractor's tax year.

The $25 million ($32 million for 2026) gross receipts test is a three-year moving average. It is calculated using the gross receipts for the three years preceding the year in which the contract was entered into. The regulations require the contractor to annualize the results of any short period included in the three-year moving average. Also, if the contractor has not been in business for three years, generally the number of years in business is used. For example, if there are only two prior years, an average of those two prior years is used.[4]

IV. Income recognition methods for small contractors

When contractors qualify for the small contractor exemption (as previously discussed), they are exempt from the requirements of §460. Accordingly, there are a number of methods available to small contractors to measure revenue from their long-term contracts. These include:

a. The percentage-of-completion method;
b. The completed-contract method;
c. The cash method; and
d. The accrual method.

We will now discuss these four methods noting their advantages and disadvantages.

A. Percentage-of-completion method

Even though a small contractor may be exempt from §460, which requires the use of the percentage-of-completion method, if desired, the contractor may still utilize this method.

1. Advantages

Since the contractor is generally required to utilize this method for U.S. GAAP financial statement reporting purposes, they will not have to maintain two sets of books – one using the percentage-of-completion method for U.S. GAAP financial statement reporting purposes and one (completed-contract, cash, or accrual) for tax reporting purposes. The amount of alternative minimum tax (AMT) adjustment may be less as well (discussed later).

2. Disadvantages

There is additional time and expense for the contractor related to internal costs and the cost of the outside CPA in keeping books and records under the percentage-of-completion method (as compared to the other methods). There may be an acceleration of recognizing taxable income over the use of the other methods.

[4] Section 448(c)(3)(A).

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B. Completed-contract method

Under this method, the contractor is able to defer any recognition of taxable income until the contract is considered complete. The major concern the contractor has in utilizing this method is determining completion. As a general rule, completion takes place when:

a. 95 percent of the total contract costs have been incurred;
b. Final completion and acceptance of the subject matter contract occurs; or
c. There is a final acceptance and completion of the contract. For example, occupancy could be an indication of completion.

1. Advantages

In most instances, the best method available is one that will allow the deferral of recognition of taxable income.

2. Disadvantages

Even though there is a deferral of recognizing taxable income in the current period, in a future taxable period, this method will require a contractor to recognize taxable income when at the same time, their cash flow may have been negatively impacted. The contractor will be required to maintain two sets of books: percentage-of-completion method for U.S. GAAP financial statement reporting purposes and completed-contract method for tax reporting purposes. In many instances, AMT will be an important consideration (discussed later in this chapter).

Losses on any contracts cannot be deducted until the contracts are completed and the income is recognized for tax purposes.

It has been reported that the IRS is scrutinizing possible misuse of utilizing this method. Some of those misuses include:

a. Improper computation of the gross receipts exemption;
b. Issues involved in considering contracts uncompleted as of year-end;
c. Warrant work categorized as construction costs and used as a reason to keep a job open;
d. Outstanding change orders used to keep a job open; and
e. Improper consideration of AMT.

C. Cash method

Under this method, income is recognized when cash is received (or when there is constructive receipt) and expenses are deducted when paid. In order to qualify for the cash method, the small contractor is required to meet two conditions:

a. Use of the cash method does not significantly distort income (if the contractor had in fact used the accrual method); and
b. If the contractor is a C corporation or a partnership with a C corporation as a partner, it must meet a three-year average of no more than $25 million in gross receipts ($32 million for 2026).

On the second requirement, it should be noted that only C corporations, partnerships with a C corporation partner, and tax shelters are forced on to the accrual method of accounting under §448(a). Tax shelters must always use the accrual method (regardless of their gross receipts level). C corporations and partnerships with a C corporation partner may use the cash method if they are under the inflation-

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adjusted gross receipts level ($32 million in 2026). Other types of entities are generally not forced on to the accrual method of accounting simply due to their gross receipts level. For example, an S corporation, partnership without a C corporation partner, or sole proprietorship may use the cash method regardless of their gross receipts level (unless another provision comes into play).

One area that could cause problems for the contractor using the cash method is how to report its inventory. The IRS has ruled that a contractor who owns inventory as of year-end is able deduct the materials and supplies in the later of:

a. The year the items are provided to a customer; or
b. The year the goods are actually paid for.

1. Advantages

The cash method is simple, thereby saving the contractor both time and potential fees paid to the outside CPA. It also creates a deferral opportunity by managing billings and acceleration of payment of costs.

2. Disadvantages

There may be an acceleration of recognizing taxable income over the use of other methods. There may be misuse in utilizing this method (using this method not in accordance with the conditions just mentioned). Additionally, the contractor will be required to maintain two sets of books: percentage-of-completion method for U.S. GAAP financial statement reporting purposes and cash method for tax reporting purposes. In many instances, AMT is still an important consideration as well (discussed later in this chapter). Contractors must spend cash to claim deductions and delay receipts to defer income, which is counter to smart business planning.

D. Accrual method

Under the accrual method, the contractor recognizes revenue similarly to other types of entities – when it is billed. However, as we will discuss shortly, this method is rarely used by the construction industry.

1. Advantages

The accrual method offers simplicity to the contractor – they are able to use the same method used to keep their internal books and records, thereby saving the contractor both time and potential fees paid to the outside CPA.

2. Disadvantages

No other method accelerates the recognition of taxable income since income is recognized when it is billed. Accrued losses on contracts are not deductible until the job is complete.

The contractor will be required to maintain two sets of books: percentage-of-completion method for U.S. GAAP financial statement reporting purposes and accrual method for tax reporting purposes.

In many instances, AMT is still an important consideration (discussed later in this chapter).

V. The 10 percent deferral election

Under §460(b)(5), a contractor utilizing the percentage-of-completion method may make an election. This election, known as the 10 percent deferral method, allows a contractor, if year-end total costs incurred for a particular job are less than 10 percent of total estimated contract costs to be incurred on the job, to

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defer the recognition of any gross profit until the job is at least 10 percent complete (which will usually occur the following tax-year).

If the contractor makes this election, it should be noted that the same rules apply for both AMT and look-back purposes, whereby if gross profit is deferred for regular purposes, it will also be deferred for AMT and look-back purposes.

Note that the rules governing both AMT and look-back will be addressed later in this chapter.

Preparers of contractor tax returns should recognize that using the 10 percent method is one of the best means available to defer recognizing taxable income.

VI. Tax cost capitalization and allocation issues facing the contractor

Similar to U.S. GAAP when preparing financial statements, the issues of which costs to capitalize and which may be currently expensed (deducted) is a major concern to the contractor when preparing its tax return. Although many costs are similar for both U.S. GAAP and tax (per §460), a number of these costs have a different treatment. In addition, tax law differentiates between regular contractors and qualified small contractors.

In addition to being exempt from the requirement to utilize the percentage-of-completion method for accounting for long-term contracts, small contractors are generally exempt from the cost capitalization rules of §460. The only exception to this rule is that they are required to capitalize interest incurred during the construction period.

Although the qualified small contractor is exempt from most provisions of §460, they are still required to capitalize direct and indirect costs incurred in the performance of the contract. Any costs incurred not related to the performance of the job are exempt from capitalization.

We will now present a comparison of cost allocation rules under the following three categories:

a. U.S. GAAP – Per FASB ASC 605-35 for financial statement preparation.
b. Tax – For contractors not qualified for the small contractor exemption under §460(e).
c. Tax – For contractors who do qualify for the small contractor exemption under §460(e).

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Key: C = Required to be capitalized as a job cost
E = Required to be expensed

	U.S. GAAP	Exempt contractor	Nonexempt contractor
Direct materials	C	C	C
Direct labor	C	C	C
Surety bonds	C	C	C
Indirect repairs	C	C	C
Indirect maintenance	C	C	C
Indirect utilities	C	C	C
Indirect rent	C	C	C
Indirect labor	C	C	C
Indirect materials	C	C	C
Indirect small tools	C	C	C
Indirect quality control	C	C	C
Indirect taxes other than income taxes	C	C	C
Indirect financial statement depreciation	C	E	E
Indirect tax return depreciation	E	C	C
Indirect contract administrative expenses	C	C	C
Indirect contract-related officer salaries	C	C	C
Indirect insurance (worker's compensation)	C	C	C
Indirect insurance (liability)	C	C	C
Indirect retirement plans	C	E	C
Indirect research and development	E	E	C
Indirect scrap and spoilage	E	E	C
Successful precontract costs	C	E	C
Indirect engineering and design	C	E	C
Indirect storage and related costs	C	E	C
Indirect transportation costs	C	C	C
Production period interest	C	C	C
Selling and advertising	E	E	E
General and administrative – not job-related	E	E	E
Officer salary – not job-related	E	E	E
Unsuccessful precontract costs	E	E	E
Research and development – not job-related	E	E	E
Depreciation of idle equipment	E	E	E
Income taxes	E	E	E
Repairs not related to production equipment	E	E	E

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Some important items to consider from the above schedule are as follows:

a. In most instances, under all three categories, a portion of officer compensation should be capitalized as a job cost unless he or she has absolutely no connection to any contract performance.
b. Income taxes (including those attributable to income from long-term contracts) are never capitalized as job costs.
c. All insurance costs directly or indirectly related to job performance should be capitalized as job costs while insurance not related to job performance should be expensed under all three methods.
d. Depreciation on idle equipment should be expensed under all three methods. Therefore, management must consider the usage of their equipment throughout the year to determine what amounts should be capitalized as job costs and what portion should be currently expensed.
e. Also, in regard to depreciation, small contractors are required to allocate financial statement depreciation (U.S. GAAP) to contracts (to the extent it does not exceed depreciation allowed for tax) while nonexempt contractors must allocate depreciation per the IRC used to complete the contractor's tax return.
f. The following costs must be capitalized for nonexempt contractors but may be currently deducted for exempt contractors:
    (i) Costs of administrative, service, or support functions;
    (ii) Indirect retirement plan expenses;
    (iii) Indirect research and development;
    (iv) Successful precontract costs;
    (v) Engineering and design; and
    (vi) Storage and related costs.

A. Job cost allocations

Similar to U.S. GAAP financial statement reporting purposes, Reg. §1.460-5 requires costs incurred to be allocated to the contractor's various jobs. There are five basic rules concerning cost allocation for tax purposes:

a. **Books and records** – The contractor is required to maintain separate accounts for each contract. Direct costs are required to be charged to the job they apply to and indirect costs must be allocated to all jobs they benefit.
b. **Direct labor** – These costs must be allocated using a specific identification method; the particular job worked on by the employee. If the direct labor costs are attributable to more than one job, they must be allocated to those jobs using a reasonable method.
c. **Direct materials** – These costs must be allocated using a specific identification method of which jobs that utilized them.
d. **Indirect costs** – These costs must be allocated using a specific allocation (whenever possible and feasible) or using some form of burden rates that result in a reasonable allocation. It should be noted that similar to U.S. GAAP, indirect costs must be allocated to both jobs completed during the year as well as those jobs still in progress as of year-end.
e. **Production period interest** – As was noted earlier in this chapter, all contractors (including small contractors as defined by §460) must capitalize production period interest and allocate these costs to all jobs benefited using a reasonable method.

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VII. AMT considerations and the contractor

Generally, every taxpayer must be concerned about the alternative minimum tax (AMT). However, for the construction industry, the impact may be even more significant. Virtually every type of contractor will be impacted from at least one aspect of the AMT. The two major exceptions to this rule are:

a. Homebuilders (as defined by the IRC and discussed previously in this chapter) who are exempt from all aspects of the AMT; and
b. C corporations. C corporations are subject to a 15 percent minimum tax due to the Inflation Reduction Act, but only when they have over $1 billion in adjusted financial statement income.

Also, as mentioned above, no alternative minimum tax adjustment is required for any residential construction contract entered into in a tax year beginning after July 4, 2025.

The following types of entities will continue to have AMT adjustments passed through:

a. S corporations – Passed through to the shareholders;
b. Partnerships – Passed through to the partners or members; and
c. Sole proprietorships.

The two most important aspects of the AMT that directly impact the construction industry are:

a. The long-term contract adjustment (in most instances, the much more significant aspect); and
b. The depreciation adjustment.

A. Long-term contract adjustment

Contractors are subject to an AMT adjustment if they utilize a method other than the percentage-of-completion method for recognizing taxable income from their long-term contracts in progress. The contractor is required to compare the difference between recognized taxable income under the method used for regular tax purposes and the amount that would have been recognized if the percentage-of-completion had been utilized.

For every pass-through entity (S corporations and partnerships/LLCs), this difference will have to be passed through to the shareholders/partners/members as an adjustment that will have to be recognized on the shareholder/partner/member's return.

It should be noted that this AMT adjustment can be a positive or negative adjustment when computing alternative minimum taxable income (AMTI) for a C corporation, or the amount to pass through to the shareholders/partners for an S corporation or partnership/LLC, depending on whether the method utilized by the contractor or the percentage-of-completion method produces a greater amount of taxable income.

Example: Eskin Construction, an S corporation, utilizes the completed-contract method for recognizing income from its long-term contracts. In 20X2, Eskin recognized $100,000 of taxable income from using this method. If the percentage-of-completion method had been used, Eskin would have recognized $300,000 of taxable income from its long-term contracts. Therefore, Eskin would be required to pass through to its shareholders $200,000 as an AMT adjustment.

For pass-through entities (S corporations and partnerships/LLCs), AMT must always be passed through to its shareholders/partners. There is no small contractor exception to this rule.

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B. The depreciation adjustment

Some important issues involving the contractor, AMT, and depreciation:

a. It affects real and personal property placed in service after 1986.

b. Similar to the long-term contract adjustment, it can result in either a positive or negative adjustment when computing AMTI, the amount passed through to the shareholders/partners/members for an S corporation or partnership/LLC.

c. The contractor is required to compute the amount of depreciation expense for regular tax purposes known as the general depreciation system (GDS), and the amount of depreciation expense if the contractor had utilized the alternative depreciation system (ADS) as defined by §56(a)(1).

d. There are two significant differences between GDS and ADS (both of which will generally result in less of a depreciation expense deduction in earlier years for AMT purposes but a greater amount in later years):

   (i) GDS generally utilizes the 200 percent declining-balance method while ADS generally utilizes the 150 percent declining-balance method; and

   (ii) For property placed in service prior to 1999, ADS generally requires a longer recovery period than GDS. Note that this provision is not applicable for assets placed in service after 1998; GDS and ADS use the same recovery period.

In many instances, the most important issue facing contractors when discussing AMT, is how to minimize the impact of the effects of this potentially imposed additional tax. Since the long-term contract adjustment generally has the greatest impact, that should be the area of contractor concern.

Probably the best way to minimize the impact of AMT is to reduce the percentage of completion recognized on jobs reported as of the year-end in the work-in-progress schedule. In other words, the more a job is considered complete (based on the percentage-of-completion calculation), the more taxable income the contractor will need to recognize,

There are generally three ways the contractor can reduce the percentage of completion and minimize their recognition of taxable income:

a. Control their subcontractors' billings;

b. Evaluate the usage of material on jobs in progress; and

c. Reevaluate the calculation of estimated costs to complete.

C. Subcontractor billings

Similar to the contractor, its subcontractors will attempt to front-end load their billings in order to collect as much cash as quickly as possible. However, any amounts billed by the subcontractor to the contractor are included in the numerator (costs incurred to date) of the percentage-of-completion formula, thereby increasing the amount of taxable income recognized by the contractor.

To minimize this problem, the contractor should attempt to only approve amounts billed by the subcontractor to work actually performed through the invoice date.

D. Uninstalled materials

What are uninstalled materials? It exists when the contract requires the contractor to purchase equipment or material at the beginning of the contract but does not allow the contractor to install the equipment or

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utilize the material on the job, and accordingly, the contractor cannot bill the owner for these particular costs.

There is a significant difference in how the contractor treats uninstalled materials between financial statement and tax reporting purposes. Per U.S. GAAP (as discussed in Chapter 3), uninstalled materials are considered the contractor's inventory and are not included as costs incurred to date. However, per the Internal Revenue Code, uninstalled materials are included in the costs incurred to date and accordingly, will increase taxable income under the percentage-of-completion method.

It should be noted this situation creates a lose-lose situation for the contractor. On the one hand, uninstalled materials create additional taxable income, but at the same time, the contractor cannot recognize these costs incurred as additional revenue for financial statement reporting purposes.

There appears to be two ways the contractor can avoid or at least minimize this situation:

a. Reword their contract with the owner which will allow them to bill for these costs at an earlier date; or
b. Attempt to minimize equipment and material purchases close to year-end to avoid or reduce the amount of uninstalled materials located at the jobsite.

E. Reevaluate estimated costs to complete

When a contractor estimates its costs to complete on open jobs as of the balance sheet date, it will compute this amount following U.S. GAAP rules. However, the rules for computing estimated costs to complete for AMT purposes are substantially different.

For AMT purposes, a significant portion of the contractor's home office overhead (general and administrative expenses) must be allocated to the various projects as indirect job costs. Therefore, since these indirect job costs must be included in the numerator (costs incurred to date), they should also be included in the estimated costs to complete (denominator). Since this will cause an increase in the estimated costs to complete, this will then result in a lower percent of completion of the job as of the year-end date which will ultimately result in less AMTI for C corporations and less of an AMT adjustment to pass through for S corporations and partnerships.

VIII. Look-back provisions

For both U.S. GAAP financial statement and IRC tax return purposes, a significant amount of net income and taxable income are subject to estimates made by management.

Accordingly, the IRS is not giving the contractor a free ride if their estimation ability is not right on target. Therefore, for those taxpayers who report under the percentage-of-completion method, §460 requires the contractor to perform a look-back calculation to account for any over or underreporting of previously recognized income while the jobs were in progress.

It should be noted that in many instances, the look-back provisions apply to both regular tax and AMT purposes. It should also be noted that most contractors will find themselves subject to these provisions.

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All construction contracts are subject to the look-back provisions with the following exceptions:

a. Home construction contracts (as previously discussed);
b. If the contractor qualified for the small contractor exemption (as discussed earlier in this chapter), those contracts whose duration are less than two years in length are exempt from look-back for regular tax, but not for AMT purposes; and
c. If the contractor is not qualified as a small contractor, all contracts are subject to the look-back provisions except those that fall under the following de minimis exception:
    (i) What is the de minimis exception? If the price of the contract does not exceed $1 million or 1 percent of average gross receipts for the past three years in which the contract was completed, that particular contract is exempt from the look-back provisions.

In addition to these three exceptions, the IRC provides the contractor with a de minimis election. This election allows the contractor to exclude any contract where the cumulative taxable income generated from the individual contract is within 10 percent of the cumulative look-back income for each prior year for which the look-back is determined.

In simple terms, the look-back calculation requires the contractor to review their prior year(s) under and/or over reporting of income from jobs-in-progress across taxable years.

Once a job is completed, the contractor is required to determine what the tax liability would have been if their estimates were fully accurate at each year-end.

For instance, Eskin Construction reported the following:

	12/31/X1	**12/31/X2**
Taxable income as originally reported	30,000	50,000
Increase (decrease) in taxable income based on the look-back calculation	10,000	(20,000)
Adjusted taxable income	40,000	30,000
Adjusted income tax liability	5,000	4,000
Original income tax liability	4,000	9,000
Increase (decrease) in tax	1,000	(5,000)

The IRC requires that interest be calculated on the over or under payment of tax. The calculated tax is the amount of interest either due to or from the IRS. It should be noted that it is not the increase or decrease in taxable income that is the contractor's responsibility under the look-back provisions, but the interest associated with the increase or decrease in the tax. For purposes of enforcement, this interest is considered additional tax.

It should be noted that if the contractor elects the 10 percent deferral method (discussed earlier in this chapter) for regular taxation purposes, it must also use this method for look-back purposes. Accordingly, for purposes of this calculation, actual total contract costs are used to determine the 10 percent threshold.

It should also be noted that the AICPA and other advocates of the CPA profession have been attempting to petition the IRS to provide relief in regard to these sometimes difficult, but always time-consuming look-back provisions. Until now, those attempts have not been successful. Apparently, the IRS has taken the position that the look-back provisions keep the contractor honest when estimating gross profit on jobs in

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progress. Accordingly, many professionals do not see any relief from these requirements in the foreseeable future.

In summary, many contractor tax return preparers may ask themselves whether they should be concerned with the provisions of look-back or simply ignore them. When addressing this issue, the preparer should keep three things in mind:

a. When it is applicable, the look-back provisions are as much a requirement as any other provision, not only §460, but the entire IRC.
b. A CPA in public practice who neglects to prepare a look-back calculation could subject themselves to IRS imposition of preparer penalties.
c. In most instances, contractors tend to overestimate gross profit from jobs-in-progress (for purposes of financial statement reporting and the surety). Accordingly, in most instances, the look-back calculation will result in a refund due to the contractor, not additional tax due.

IX. Home construction contract tax issues

Many of the issues we have been discussing until now relate to both commercial construction contracts and home construction contracts. However, there are some exceptions to these rules related to home construction contracts (defined earlier this chapter) that exempt them from §460. These will now be discussed.

In order to deal with home construction contracts, it must be understood there are two types of home construction contractors:

a. **Contract builder** – Home construction is performed under the terms of a contract; and
b. **Spec builder** – Home construction is performed without a contract and sold at a later date.

It must also be understood that there are differences in taxation if the homebuilder qualifies as a small contractor or does not qualify as a small contractor.

A. Contract builders

There is no difference between those homebuilders who qualify as a small contractor and those who do not qualify as a small contractor for revenue recognition purposes. Both may use the percentage-of-completion, completed-contract, accrual, or cash methods of recognizing revenue from long-term contracts.

The cost capitalization rules are substantially similar to commercial contractors, including the requirement to capitalize production period interest.

AMT does not apply for either those homebuilders who qualify as a small contractor or those who do not qualify.

B. Spec builders

There is no difference between those homebuilders who qualify as a small contractor and those who do not qualify as a small contractor for revenue recognition purposes; both should utilize the deferred accrual method, which is to a large extent the completed-contract method signifying that no income is recognized

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until closing occurs. This would be demonstrated when there is a transfer of title from the builder to the buyer.

There is a difference in cost capitalization between those homebuilders who qualify as a small contractor and those who do not qualify:

a. **Homebuilders who qualify as a small contractor** – Should capitalize costs under the tax code as it existed before TAMRA '88 (which is substantially the same as §460 with a few exceptions), including the requirement to capitalize production period interest.
b. **Homebuilders who do not qualify as a small contractor** – Exempt from cost capitalization rules under §460 but are subject to capitalization rules under §263(A). It should be noted that this is not a major issue as the two sections are basically the same.

AMT does not apply for both those homebuilders who qualify as a small contractor and those who do not qualify.

It should be noted that the Tax Cuts and Jobs Act that became effective in 2018 made some changes regarding taxation of homebuilders. Homebuilders whose revenue does not exceed $25 million ($32 million in 2026) are exempt from having to capitalize certain general and administrative costs to inventory under §263A.

To summarize the key points concerning taxation of homebuilders:

a. Production period interest must be capitalized under all circumstances;
b. Spec builders receive the most favorable tax treatment; and
c. AMT never applies under all circumstances.

X. Other tax issues related to the construction industry

We will touch briefly on several recent tax changes related to those in the construction industry.

A. Overall limit on business losses – §461

Many construction companies may be formed as flow-through entities. Given the relatively high supplier, materials, and fixed asset costs, it is not uncommon for a construction company to have losses (especially in the early years of its existence). The TCJA added §461, which provided for an overall limit on business losses that may be taken by individual taxpayers. In addition to the normal loss limitations (such as partner or S corporation shareholder basis limitations), §461 provides an additional loss layer. For tax year 2025, losses are limited to $626,000 for married taxpayers ($313,000 for others). The One Big Beautiful Bill Act made the provisions permanent.

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B. Bonus depreciation – §168(k)

The TCJA temporarily increased bonus depreciation to 100 percent. This allowed construction companies (as well as other companies) to write off the entire cost of fixed assets right away resulting in significant cost savings. However, for property placed in service after 2022, the percentage of cost that may be deducted as bonus depreciation decreases:

a. 2023 – 80 percent bonus depreciation
b. 2024 – 60 percent bonus depreciation
c. 2025 – 40 percent bonus depreciation
d. 2026 – 20 percent bonus depreciation
e. 2027 and later – No bonus depreciation

For property acquired and placed in service after January 19, 2025, 100 percent bonus depreciation is restored. Qualified property acquired before January 20, 2025, is subject to the prior bonus depreciation rates for the year the property is placed in service (see above – 40 percent for 2025, 60 percent for 2024, etc.). For this purpose, if a written binding contract for the acquisition of property is in effect prior to January 20, 2025, the property is not considered acquired after the date the contract is entered into.[5] For example, if a contract is entered into on January 6, 2025, and the property is placed in service on February 28, 2025, the property would not be eligible for 100 percent depreciation. It would only be eligible for 40 percent depreciation.

C. Meals deduction – 50 percent

Starting in 2023, the meals deduction returns to 50 percent. For tax years 2021 and 2022, a deduction was allowed for 100 percent of restaurant meals.

For tax years after 2025, employer-provided meals are nondeductible if they are excludable from an employee's income under section 119(a) or they are for food and beverages that qualify as a de minimis fringe benefit to the employee under section 132(e).

D. Green Energy Credits

The One Big Beautiful Bill Act eliminated many green energy incentives provided by the Inflation Reduction Act. However, it should be noted that some may still be taken advantage of before they expire.

1. Energy-efficient home credit for contractors and manufacturers – §45L

There is a credit available for energy-efficient single-family homes of either $2,500 or $5,000 (depending on energy savings). The credit is $500 or $1,000 per dwelling unit (depending on energy savings) for multifamily complexes. In either case, the maximum credit will apply in the case of a zero-energy home.

The credit will not be allowed for any qualified new energy-efficient home acquired after June 30, 2026.

2. Deduction for energy-efficient buildings – §179D

The deduction for the cost of putting an energy-efficient building into service was expanded and modified by the Inflation Reduction Act. In order to be energy-efficient, starting in 2023, the building must reduce annual power and energy costs by at least 25 percent. Also, in 2025, the deduction is calculated as the square footage of the building is multiplied by $0.58 increased (but not above $1.16) by $0.02 for each

[5] Act §70301(c)(4) of the OBBBA.

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percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than the baseline 25 percent.

The deduction will not be allowed with respect to any property the construction of which begins after June 30, 2026.

3. Energy-efficient residential property improvements credit – §25C

The Inflation Reduction Act provides an increased 30 percent credit generally with a maximum annual $1,200 credit limitation for qualified energy-efficient residential property improvements after 2022 and before 2033. The maximum credit for any taxable year resulting from expenditures for all exterior windows and skylights may not exceed $600. Additionally, the maximum credit for a taxable year may not exceed $250 for any one exterior door and $500 for all exterior doors. Also, a $150 credit is available for home energy audits.

In 2025, §25C (the energy-efficient home improvement credit) requires manufacturers of eligible products to register with the IRS as qualified manufacturers (QMs). The IRS will assign a product identification number (PIN) to each item – and taxpayers are required to report this PIN on their tax returns in order to claim the credit.

Under the OBBBA, the credit will not be allowed for any property placed in service after December 31, 2025.

XI. Employee vs. independent contractor issues

The IRS is continuing to attack how entities treat certain persons who perform work as independent contractors rather than as employees. It has been reported that they have targeted the construction industry where they believe there may be substantial abuse exhibited by some contractors inappropriately granting a worker independent contractor status when the facts and circumstances indicate that the worker should be classified as an employee.

The costs to the contractor who is required by the IRS to reclassify workers from independent contractors to employee status will be substantial and could result in the demise of the entity. These costs may include:

a. Additional payroll taxes (FICA, Medicare, unemployment), in addition to applicable penalties and interest;
b. Potential back overtime pay under the applicable state's wage and hour laws; and
c. Additional potential retirement plan contributions.

The current guidance on this issue is Rev. Rul. 87-41, which lists 20 factors and three categories of control that provides the necessary guidance whether an employer-employee relationship exists. These factors were based on the circumstances that the courts identified and relied upon when deciding whether an employment relationship existed. It should be noted that not all of the factors need to be present to determine either an employer-employee relationship or an independent contractor status. These factors and categories of control are to be considered a guide to the contractor to allow them to assess the likelihood as to whether an individual is an employee or an independent contractor.

The three additional categories listed after these 20 factors are as the result of the IRS recognizing changes in business practices (including the construction industry) since 1987 and, therefore, created

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these three categories of factors to assess the degree of control and independence between the entity and the individual. These three additional categories are to be used by the contractor in conjunction with the 20 factors that will now be listed.

A. 20 factors for consideration by the contractor

1. Instructions

An employee must comply with instructions when, where, and how to work. The control factor is present if the contractor has the right to require compliance with its instructions.

2. Training

An employee receives ongoing training from, or at the direction of the contractor. Independent contractors use their own methods and receive no training from the purchasers of their services. For the construction industry, because of the very nature of the work performed by its workers, this may be considered one of the most important factors when making the employer-employee vs. independent contractor determination.

3. Integration

An employee's services are integrated into the construction operations because the services are important to the contractor. This shows that the worker is subject to direction and control of the contractor and therefore will generally be classified as an employee.

4. Services rendered personally

If the services must be rendered personally, presumably the contractor is interested in the methods used to accomplish the work as well as the end results. An employee often does not have the ability to assign that work to other employees, while an independent contractor may assign work to others.

5. Hiring, supervising, and paying assistants

If a contractor hires, supervises, and pays assistants, the worker is generally categorized as an employee. An independent contractor hires, supervises, and pays assistants under a contract that requires them to provide materials and labor and to be responsible only for the results.

6. Continuing relationship

A continuing relationship between the worker and the contractor indicates that an employer-employee relationship exists. The IRS has found that continuing relationships may exist when work is performed at frequently recurring intervals, even if the intervals are irregular.

7. Set hours a week

A worker who has set hours of work established by a contractor is generally an employee. An independent contractor sets his or her own hours.

8. Full time required

An employee normally works full time for a contractor. An independent contractor is free to work when and for whom he or she chooses.

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9. Work done on premises

Work performed on the premises of the contractor (jobsite) for whom the services are performed suggest employer control, and therefore, the worker may be an employee. Independent contractors may perform the work wherever they desire as long as the contract requirements are performed.

10. Order or sequence set

A worker must perform services in the order or sequence set by a contractor and is generally an employee. Independent contractors perform the work in whatever order sequence they so desire.

11. Oral or written reports

A requirement that the worker submit regular or written reports to the contractor indicates a degree of control by the entity and suggests an employer-employee relationship.

12. Payments by the hour, week, or month

Payments made by the hour, week, or month generally point to an employer-employee relationship.

13. Payment of expenses

If the contractor generally pays the worker's business and/or travel expenses, the worker is ordinarily an employee.

14. Furnishing of tools and materials

If the contractor furnishes significant tools, materials, and other equipment that would normally be supplied by an employer, the worker would generally be considered an employee.

15. Significant investment

If a worker has a significant investment in the facilities where they perform their services, the worker may be classified as an independent contractor.

16. Profit or loss

If the worker can make a profit or incur a loss, the worker may be an independent contractor. Employees are typically paid for their time and labor and have no liability for the contractor's expenses or liabilities.

17. Working for more than one contractor at a time

If a worker performs construction services for a number of unrelated contractors at the same time, the worker may be considered an independent contractor.

18. Making contracting services available to the general public

If a worker makes their contracting services available to the general public on a regular and consistent basis, the worker may be an independent contractor.

19. Right to discharge

The contractor's right to discharge a worker is a factor indicating that the worker is involved in an employer-employee relationship.

20. Right to terminate

If the worker can quit work at any time without incurring liability, the worker is generally considered an employee.

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B. Categories of control factors for additional consideration by the contractor

1. Behavioral control

Includes the type of instructions the contractor gives to the worker, such as when and where to do the work, and the training the contractor provides to the worker. The key consideration is whether the contractor has the right to control the details of the worker's performance or has established that right.

2. Financial control

Addresses the contractor's rights to control the business aspects of the worker's job.

3. Relationship of the parties

The nature of the relationship may be evidenced by:

a. A written contract;
b. The benefits provided to the employee, such as paid vacation and health coverage;
c. The permanency of the position; and
d. The extent to which the services performed is a key aspect of the construction work of the contractor.

Obviously, the contractor will want to classify as many workers as possible as independent contractors in order to avoid paying the related payroll taxes, workers' compensation insurance, health insurance, and retirement plan contributions generally associated with employee status. However, if this position was challenged by the IRS, it appears that the burden of proof will be on the contractor to prove that the worker was an independent contractor and not an employee. The more factors and conditions listed above that support the contractor's position, the greater the possibility the IRS will accept their position. Accordingly, the contractor (together with their outside CPA) must be sure to thoroughly document their position. And finally, when the contractor is bidding on a job, they may want to include a contingency for these additional costs should the IRS impose the reclassification.

XII. FIN 48

There is one issue that contractors must deal with involving both their tax returns and financial statements prepared in accordance with U.S. GAAP. This issue deals with uncertain and aggressive positions taken on the tax return and its potential impact on the related financial statements. This issue is commonly referred to as FIN 48.

The source of U.S. GAAP concerning FIN 48 is FASB ASC 740, *Income Taxes.*

In June 2006, the FASB issued FIN 48, *Accounting for Uncertainty for Income Taxes* (in conjunction with SFAS No. 109). It is now applicable to every financial statement prepared in accordance with U.S. GAAP.

The theory behind FIN 48 is that when an entity is preparing its tax returns, they may take uncertain, aggressive positions on those returns. Senior management may be advised that these positions may fall into a gray area and in the event of an examination by the IRS or any other taxing authority sometime in a future year, the uncertain/aggressive positions could be disallowed. This in turn could result in not only an additional tax assessment, but the possibility of additional assessed interest and penalties.

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However, historically, when the entity prepares its financial statements in the year the uncertain/ aggressive positions are taken, no disclosure or accrual for potential additional tax, interest, and penalties, have been made. Therefore, FIN 48 instructs the entity that when preparing their financial statements, they should accrue (for C corporations) or disclose (for all entities) the potential impact of a government examination of the entity's tax return if it is management's position that it is more likely than not (greater than 50 percent) that the uncertain/aggressive position will be disallowed by the taxing authority.

It should be noted that for FIN 48 purposes, it is always assumed that every tax return will be examined by the applicable authorities, whether it is:

a. Federal;
b. State;
c. Local; and
d. Franchise.

Any tax that is based on income is subject to the provisions of FIN 48.

What are some issues that may cause FIN 48 to have an impact on contractor-related financial statements because of uncertain/aggressive positions taken on the tax return?

a. The method of revenue recognition used for long-term contracts (i.e., improper use of the completed-contract, cash, or accrual methods).
b. The entity not fully being in compliance with nexus issues in those jurisdictions where they may have performed their construction work, which may have resulted in the payment of additional taxes in those jurisdictions. For contractors, this may be a very prevalent issue since many contractors perform work in many different states and local localities.
c. Ignoring various AMT issues.
d. Ignoring look-back provisions.
e. When using the completed-contract method, considering a job only 94 percent complete as of the reporting date, whereas the IRC requires recognition of gross profit from the contract when it is considered at least 95 percent complete.

XIII. Most common tax mistakes for contractors

There are three common mistakes made by preparers of contractor tax returns:

a. Improperly using the percentage-of-completion method on exempt contracts;
b. Failing to utilize the 10 percent deferral election related to the percentage-of-completion method; and
c. Missing out on refunds from the IRS from the look-back provisions for those contracts that recognize profit fade.

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XIV. Summary

To summarize the importance of the outside CPA having a thorough knowledge of not only U.S. GAAP and financial statement preparation issues, but the IRC (in particular, §460), we must ask the question, what is the primary reason CPAs are involved in litigation with their construction clients?

The answer is not a surety or bank seeking recovery as the result of relying upon financial statements audited or reviewed by the outside CPA which were subsequently determined to contain material U.S. GAAP misstatements which ultimately resulted in the surety incurring significant losses. Rather, it results from legal action brought on by the client due to the improper preparation of their various tax returns and it was alleged that the outside CPA was lacking the necessary knowledge to prepare those returns in accordance with the IRC.

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