CHOOSING A CPA FOR YOUR CONSTRUCTION COMPANY

A contractor can qualify a potential CPA by focusing on specific criteria.

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For today's contractor to achieve financial success, a strong management team is a prerequisite. In addition to competent management, a team of knowledgeable outside advisors is vital. That team usually consists of an attorney, banker, surety, and a Certified Public Accountant (CPA). Construction accounting and taxation require specialized industry knowledge not required of a general practitioner CPA.

A CPA uneducated in the unique accounting requirements for contractors, and ignorant of the special income tax requirements and elections available in the Internal Revenue Code, can cost a contractor significantly. Therefore, choosing a CPA to perform external accounting functions such as an audit, review, compilation, tax planning, and consulting is a process that should receive serious attention.

Often, the basis on which this decision (choosing a CPA) is made has little foundation and results in needless costs. To help avoid this problem, this article will list areas of focus and sample questions and responses that should be used by a contractor's management to evaluate a CPA's competence in the field of construction accounting and taxation.

Experience

Question: Describe your construction experience and an approximate percentage of time devoted to construction clients over the course of a year.

Response: A CPA should have a resume detailing his/her background and work experience. A contractor should look for the depth of involvement in the construction industry. Items such as articles written for construction magazines, construction seminars presented, speeches given, membership in construction organizations maintained, and specific construction-related designations, all demonstrate a commitment to the field of construction. Also, CPAs that have work experience in the private construction sector may be able to better relate to the difficulties of running a construction company. This is especially important if a CPA has worked for the same type of contractor (i.e., a general, electrical, or highway contractor).

When examining a CPA's public accounting experience, a contractor should ask for a percentage breakdown of the CPA's current construction clients in relation to the clients as a whole. A high percentage of contractor clients should provide evidence of the CPA's experience in the construction industry. A CPA or CPA firm servic-

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ing just 2 or 3 clients in the construction industry might not be current concerning changes occurring in rules and regulations concerning construction accounting and taxation.

Finally, contractors should contact their current bonding agents, bankers, and lawyers in the community for advice about CPAs and their level of accounting experience. Often, these professionals can provide valuable advice about choosing a competent CPA. A CPA with an excellent reputation in the professional construction community should always be a candidate for hire.

WITH ALL OF THE DIFFERENT ACCOUNTING METHODS AVAILABLE TO A CONTRACTOR, IT IS IMPERATIVE THAT CPAS UNDERSTAND THE OPTIONS AVAILABLE.

Accounting and auditing

Question: What is Statement of Position (SOP) 81-1, and why is it important to contractors?

Response: SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* provides guidance on the application of generally accepted accounting principles in accounting for the performance of contracts. This is the most important procedure when preparing financial statements for a contractor, and also the one most subject to material errors. Paragraph 2 of SOP 81-1 states:

> The determination of the point or points at which revenue should be recognized as earned and costs should be recognized as expenses is a major accounting issue common to all business enterprises engaged in the performance of contracts of the types covered by this statement. Accounting for such contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods. This involves considerable use of estimates in determining revenues, costs, and profits and in assigning the amounts to accounting periods. The process is complicated by the need to evaluate continually the uncertainties inherent in the performance of contracts and by the need to rely on estimates of revenues, costs, and the extent of progress toward completion.

As stated above, preparing the contracts in progress schedule for financial statements is complicated! Therefore, it is imperative that a CPA who is preparing contract schedules possess a thorough understanding of the principles that govern the financial statements. Understanding SOP 81-1 is essential in order to successfully perform that task.

Question: What are the two generally accepted methods of accounting for long-term construction-type contracts for financial reporting purposes?

Response: As stated in Paragraph 4 of SOP 81-1:

- The *percentage-of-completion method* recognizes income as work on a contract progresses; recognition of revenues and profits generally is related to costs incurred in providing the services required under the contract.

- The *completed-contract method* recognizes income only when the contract is completed, or substantially so, and all costs and related revenues are reported as deferred items in the balance sheet until that time.

SOP 81-1 *recommends the percentage-of-completion method* when estimates are reasonably dependable. There is a presumption that contractors generally have the ability to produce estimates that are reliable enough to justify the percentage-of-completion method. Paragraph 24 of SOP 81-1 states, "The ability to produce reasonably dependable estimates is an essential element of the contracting business." Therefore, it is *rare* when a contractor uses the completed-contract method for financial statement purposes.

Taxation

Question: When a construction company files its initial tax return, is the percentage-of-completion method required for tax purposes?

Response: Yes, EXCEPT for the exceptions enumerated. IRC section 460 requires that the percentage-of-completion method be used for all long-term contracts that are not exempt under the rules.

However, there are many exemptions subject to certain restrictions. IRC section 460(e)(1)(B) describes the small contractor exception to the 460 PCM requirements.

Question: What are the choices for income taxation if a contractor qualifies for exemption from IRC section 460?

Response: Every contractor elects an overall method of accounting on its first filed federal tax return. The choices include cash, hybrid (part cash, part accrual method), accrual, accrual excluding retention, completed contract, exempt percentage-of-completion, percentage-of-completion, simplified cost-to-cost method, percentage-of-completion/capitalized-cost method, and the 10% deferral method. However, a contractor's accounting method can change if it grows in revenue and types of contracts performed.

For example, a contractor formed as a C-type corporation could elect the cash method on the initial return. However, once average annual gross receipts exceed $5 million, the cash method is no longer allowable (to a C-type corporation). With all of the different accounting methods available to a contractor, it is imperative that CPAs understand the options available.

Question: What is the test for the small contractor exemption under IRC section 460(e), and why is it important?

Response: In order to qualify as a small contractor, average gross receipts for the three previous tax years cannot exceed $10 million. If the small contractor exemption is met, the contractor is not required to report income under the percentage-of-completion method. It may use its normal method or select an acceptable method.

Question: How would long-term contracts be reported under the final code section 460 regulations when switching from the percentage-of-completion method to the completed-contract method?

Response: The contractor would report any change in such method under an immediate cut-off, as long as the contractor initiates the change. Under an immediate cut-off, gross profit from qualifying contracts in progress in the year of change will be deferred until the year completed. In the case of switching from the PCM to the CCM, the first year of change would result in a negative 481(a) adjustment. In other words, there is no adjustment for prior-year contracts. Understanding the cut-off method can have a significant influence on the company's ability to defer large amounts of tax.

Question: What is Form 8697, and who is required to file?

Response: Form 8697 is "Interest Computation Under the Look-Back Method for Completed Long-Term Contracts." Once a long-term contract is completed, Form 8697 requires the contractor to "look-back" to the prior taxable years and determine if the gross profit on the long-term contract while it was in progress was either over- or underestimated. Based on the results of this computation, the contractor will either pay the IRS interest for underestimated gross profit or receive interest for overestimated gross profit. Form 8697 assures that neither the taxpayer nor the IRS will lose the "time value of money" on income taxes that should or should not have been paid on income from a long-term contract. Contractors who experience profit-fade may receive substantial refunds for interest on overpayment of taxes. Unfortunately, many inexperienced CPAs never file Form 8697. If the company is due a refund and the form is never filed, the money will stay with the IRS and be lost forever once the statute of limitations to file Form 8697 expires.

IF THE SMALL CONTRACTOR EXEMPTION IS MET, THE CONTRACTOR IS NOT REQUIRED TO REPORT INCOME UNDER THE PERCENTAGE-OF-COMPLETION METHOD.

The look-back method does not apply in the following cases if the election is made:

- If in the completion year, for each prior contract year, the cumulative taxable income (or loss) actually reported under the contract is within 10% of the cumulative look-back income (or loss).
- In a post-completion year, if, as of the close of the post-completion year, the cumulative taxable income (or loss) under the contracts is within 10% of the cumulative look-back income (or loss) under the contract as of the close of the most recent year in which the look-back method was applied to the contract (or would have been applied if the election had not been made).

Once this election is made it applies to all contracts completed during the election year and all later tax years, and may not be revoked without IRS consent. If the election is not made with the return, then it may be filed within 6 months after the due date of the tax return.

A taxpayer may also elect not to apply the look-back method for a contract required to be included in the calculation until the first tax year in which at least 10% of the estimated total contract costs have been incurred. This, as stated previously, is an election that may be made and it is also for all contracts for the election year and later tax years.

If there are adjustments to a contract price or contract costs after the contract is completed, for any reason, then one must apply the look-back method in the year such amounts are properly taken into account, even if no contract is completed that year.

BEFORE A CONTRACTOR INVESTS A SUBSTANTIAL SUM INTO AN ACCOUNTING PACKAGE, IT IS CRITICAL THAT THE CONTRACTOR UNDERSTANDS ITS PARTICULAR NEEDS AND WHETHER THE SOFTWARE WILL MEET THOSE NEEDS.

Consulting

Question: Describe the features required for an accounting software system to adequately meet the needs of a medium sized contractor.

Response: This is an area where some construction accounting knowledge can pay off. Before a contractor invests a substantial sum into an accounting package, it is critical that the contractor understands its particular needs and whether the software will meet those needs. Some areas to consider are:

1. *Calculate and record retainage properly*. Many contractors hold retainage on invoices received from subcontractors and have retainage held by customers on billings. Contracting software should allow the retainage amount to be set for each specific job in the new job setup process. The system should then deduct retainage from all subcontractor invoices received and billings mailed out for the amount specified for each particular job. On all aging reports for accounts receivable and payable, the retainage should be separated from regular payables and receivables. This is an important control feature. It will help to ensure that subcontractors are not overpaid and the contractor is not underpaid both during the course of the job and when the job is complete. Also, percentage-of-completion calculations will be incorrect if retainage is not included in the job cost and billings for each job. Without accurate calculations, the financial statements will be incorrect as well.
2. *Create A.I.A. form billings*. Many contractors are required to submit A.I.A. form billings on at least some jobs during the course of a business cycle. A.I.A. billings provide a great amount of information about the job, such as contract amount plus change orders to date, work completed, a schedule of values, and retainage held. When creating a new job, the client keys this information into the system. A good contracting software uses this information to create the A.I.A. billing. This saves time by eliminating unnecessary duplication while increasing accuracy. It also aids in job tracking and releasing billings in a timely fashion.
3. *Post cost to jobs by cost code and phase*. When recording job costs in the accounting systems, the software should prompt the user to post the costs to a job. For job cost accounts, users should not be able to post costs to these accounts without assigning a job. It also should allow the contractor to post to phases as well. The system should then generate a report that reconciles the costs separated by job and account number back to the general ledger. This is a critical control step that accountants can use to reconcile job costs. Many contracting software programs cannot perform this step.
4. *Allocate costs to jobs*. The software should allow the contractor to allocate indirect costs to jobs. For contractors, job reports that do not include indirect costs are inaccurate in the calculation of gross profit. By allocating indirect costs, management can understand its true cost of doing business and maintain tighter cost controls.
5. *Prepare the contracts-in-progress schedule*. In order for the financial statements to be useful, a contracts-in-progress schedule must be created. Many software programs can generate a report to calculate over- and underbillings. This gives the company the ability to generate internal financial statements on a timely basis and with greater accuracy. It then allows the company to monitor change orders and job status more often. Time can be spent analyzing the job schedule

instead of pulling the information together.
6. *Create certified payroll*. Any contractor who has prepared certified payroll forms know how tedious they can be. Many contracts require certified payroll, and software that will generate a certified payroll report can lower the administrative burden.

It may be hard to find software that can perform all of these tasks and still meet the budget. However, by understanding this information before purchasing, the contractor can decide which features are the most important and eliminate surprises after the software is installed.

Conclusion

A contractor can qualify a potential CPA by focusing on specific criteria. Once a certain level of expertise is determined, the contractor can evaluate other areas of importance. For example, one should always check the license status of a potential CPA with their state board of accountancy. Also, to maintain a successful long-term working relationship the contractor should consider compatibility. Matching business styles and attitudes can greatly influence communication between the CPA and the contractor.

It is clear that in order to maximize the benefits of a CPA, contractors need to hire a *construction* CPA. ■