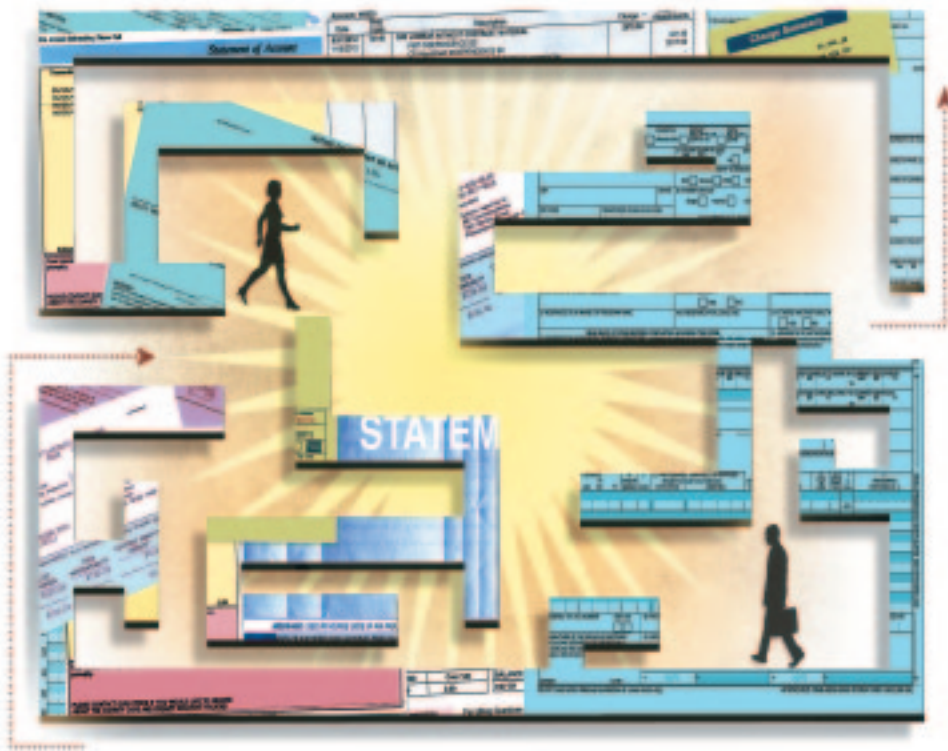


FINANCIAL Vs. INCOME TAX REPORTING

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Many contractors wonder why the amount of net income on their financial statements differs from the amount of taxable income on their tax returns. Simply stated, the Internal Revenue Service (IRS) allows different methods of accounting for construction contracts for income tax reporting purposes, as opposed to financial statements that usually are required to be based on generally accepted accounting principles (GAAP).

Following are several scenarios that may differentiate construction contractors' financial reporting from their income tax reporting.

GAAP

In accordance with GAAP, a contractor's financial statement should be based on the percentage of completion method (PCM)

of accounting for all long-term contracts. Disclosures should include:

- detailed notes on the financial statements;
- contracts receivable aging;
- a breakout of contracts and retention receivables by contracts in progress and jobs completed;
- an earnings from contracts schedule that ties the contracts in progress and completed during the year to the statement of income; and
- a contracts in progress and completed contracts schedule that illustrate the contract revenues, costs and gross profits by project for the accounting period.

COST TO COMPLETE

Contractor financial statements rely heavily on estimates. One datum critical to the contractor is the estimated cost to complete on contracts in progress (ECCCP). Without accurately determining the ECCCP, a contractor's financials can fluctuate wildly from one month to the next. Changing these estimates can impact financial statements significantly, so contractors should take this task very seriously.

DEPRECIATION

Depreciation is another important estimate for contractors with equipment-intensive businesses. If the equipment's useful life is not correct, the contractor could be charging an excessive amount of expense to a project, which would negatively impact profitability.

Contractors often incorrectly use the same depreciable lives and methods for financial statement and income tax reporting, which can result in significantly understating equity by using an accelerated tax method.

PCM

If a construction contract is long term, contractors are required to use the PCM for income tax reporting purposes. Exemptions exist for a home construction contract or if the taxpayer meets the small contractor exception. The following two requirements must be met for the small contractor exception to apply.

- At the time the contract was entered into, it was estimated to be completed within a two-year period beginning on the commencement date of the contract.
- The contractor's average annual gross receipts for the three taxable years preceding the year in which the contract was entered does not exceed \$10 million.

Average annual gross receipts are measured on the revenue reported for income tax purposes. Therefore, it is necessary to apply proper tax reporting to exempt and non-exempt Internal Revenue Code section 460 (IRC 460) contracts to avoid inadvertently overstating gross receipts. The three years is reviewed on a current and forward-looking basis. In a year that the small contract exemption is not met, only contracts that start

in subsequent years are required to be reported on PCM. Existing contracts will remain exempt from IRC 460 and the company will continue to use the elected method of accounting for income tax purposes until the job is complete. Conversely, a large contractor that eventually meets the small contractor exemption may begin using whatever exempt method it had used previously on its new exempt contracts.

CPAs often spend a lot of time trying to maintain small contractor status to avoid reporting under the PCM. But a variety of deferral options are available to large contractors under IRC 460, including:

- 10 percent elective deferral;
- residential contracts;
- retainage receivable and payable; and
- methodologies to allocate general, administrative and overhead (G&A) costs.

Additionally, firms often overlook that applicable methods of tax accounting are determined on a contract-by-contract basis. As such, a contractor could be reporting revenue from construction contracts under several methods of accounting that all produce different results.

INCOME TAX METHODS

- **Cash basis.** This method calculates income based on the inflow and outflow of cash. Accounts receivable, retainage, work in progress and prepaid assets are not considered part of income for tax purposes until realized (collected or paid). Because this method results in deferrals, contractors often show a significant income for financial statement purposes while showing a loss for income tax reporting purposes. To qualify for the cash basis method, contractors cannot have significant inventories, be required to maintain inventory or average more than \$10 million (\$5 million for C corporations) in gross receipts for the prior three years (as measured on the income tax return). The use of the cash method also cannot significantly distort income. Usually, qualifying for the cash method will result in lower taxes than any other income tax method.
- **Accrual.** This method reports income from construction contracts as progress billings are made and deducts expenses as job costs are incurred. This may result in the contractor showing significant income for financial statement purposes

while minimizing taxable income. Over-billings increase taxable income and under-billings decrease taxable income.

- **Accrual less retainage.** Retainage occurs when a percentage of billings for services performed is withheld by the customer until completion. A contractor can establish a method of accounting to defer retainage receivables from accrual basis income until it receives a green light on completion and acceptance from the customer. This method could create a significant income deferral for small contractors exempt from IRC 460. Large contractors that elect this method may benefit on short-term contracts if retainage receivables or retainage payables are outstanding at year-end.
- **Completed contract method (CCM).** This is one of the most commonly used methods for exempt contracts because all contract revenue and related contract costs are deferred until the job is finished. A contract is considered complete when at least 95 percent of contract costs have been incurred and the customer has use of the property. The contractor then must report the remaining total

contract revenue in the year the contract is deemed (for IRS purposes) to be complete and account for all remaining costs in subsequent years under its overall method of accounting. Additionally, the CCM is not a permissible method for alternative minimum tax (AMT) and is thus a tax preference item.

- **Cost allocation.** Under IRC 460, a contractor must allocate additional G&A costs to contracts when costs already are allocated for financial statement purposes. In general, all costs that directly benefit or are incurred by the long-term contract's performance must be allocated to each long-term contract. Allocating G&A costs incurred to date allows contractors to estimate future G&A costs to be incurred on that contract job in progress. In all likelihood, the percentage complete and the revenue recognized to date will be different. Establishing a methodology to estimate future G&A costs to be incurred, thus complying with the requirements of IRC 460, will result in a different gross profit on contracts for income tax purposes.
- **10 percent elective deferral.** Under IRC

460, a contractor may defer recognition of gross profit until the job is at least 10 percent complete. This is a one-time election and applies to all long-term contracts entered into during and after the electing year.

BEST PRACTICES

To properly advise contractors, CPAs must understand GAAP and the income tax rules and provisions under IRC 460, as well as be able to identify the contracts that lend themselves to deferral opportunities. The work in process schedules for open and closed jobs is a great place to start and should be reviewed for the type of work being performed and the percent complete. CPAs should look through each contract to understand the intended use of the project on which the work is being performed.

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