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CONSTRUCTION ACCOUNTING

HOW IT CAN MAKE OR BREAK YOUR BUSINESS

2024 EDITION

Accounting & financial management in every industry is tough work. The construction industry, due to all its variables, is extremely complex.

Not for the faint of heart or the novice.

Construction Accounting
Preface

Construction accounting is a unique form of bookkeeping and financial management. It has been developed over the years to specifically help contractors keep track of every aspect of cost and profitability in a project. Contractors know there is a lot to keep track of to do the job and remain profitable. Tracking the multitude of variables for each job and the need to report how it affects the company as a whole is not for the faint of heart.

The degree in which a contractor practices construction accounting will determine whether they become a financial powerhouse, a company doing well, but leaving money on the table or worse, doomed to uneven cash flows, paying penalties and/or insolvency.

Accounting and financial management in every industry is tough work. The construction industry, due to all its variables, is extremely complex.

The varying lengths of contracts, transient workforce, market prices of materials, the list goes on and on...those are just some of the elements that make it a real challenge. If your accountant is not trained in construction accounting, it is likely they will find themselves quickly over their heads.

To gain some perspective on how few construction accountants there are out there consider this; Higher education in regards to teaching accounting, spends about 80% of their curriculum time on general accounting, 15% on construction accounting and 5% on manufacturing accounting. So accountants who go into construction accounting have to continue their education to hone their craft. A scant few do. It's hard.

Rather than simply taking records of debits and credits like other businesses would, accountants in the construction industry must use sophisticated accounting solutions to make sure a system is in place to match income and expenses accurately.

While it draws on all the same basic principles of general accounting, it also has several important and distinct features.

Let's take a look.

Job Costing

Typically most businesses use a centralized general ledger in accounting to keep track of the financial transactions that impact the firm's business health. Aside from minor modifications due to their specific industry, that is all they will need. However, construction accounting is a decentralized, project-focused form of accounting that strives to keep track of each job and report on all of the transactions that occur on that job. The practice of tracking costs and attaching those costs to particular projects and production activities is called job costing.

For those in the construction industry, job costing and general ledger work together to create a more clear financial picture for the company. Job costing looks at what is occuring transactionally on a project level, like foundation, framing costs,or labor costs, while the general ledger looks at the activities of the firm on a macro level. It can be a daunting task keeping everything on track and accounted for.

Measurements are identified by units for physical completion, dollars for costs, and hours for labor used. They also need to be classified using a system that helps identify the transaction, and tag that to a specific job invoice labeling it "Job 250" and for materials "MAT" could be used as an example.

The intricacies can get more detailed if costs are categorized by project phases or sub-jobs, like framing or foundation of a structure while it's being built. The system of these categories contractors use across all of their jobs is called the job cost structure.

"the complexities of construction accounting are such that without an experienced accountant working with you, you're most likely to miss an opportunity"

Tobin Moon - Partner at TYS

Contract Revenue Recognition

Revenue recognition of income is how contractors determine if they are actually making any money on a project. It helps determine when to record an expense. Due to the nature of the industry, construction contracts tend to be long-term in nature and often have a delayed payment structure. Unlike other industries, contractors normally can't complete the project, bill, and collect on it all in the same month. For larger projects, this never happens.

That leaves contractors and construction accountants with a choice of revenue recognition method. The method they choose will determine when income and expenses "count." In some cases, they might use one method for their own bookkeeping and one for tax reporting, as long as they remain consistent over time.
In construction accounting, the main options have traditionally included cash-basis, completed contract and percentage of completion. However, contractors now have to consider guidance from the relatively new - ASC 606

Contract Revenue Recognition (continued)

revenue recognition standards with their construction CPA. To properly recognize revenue under ASC 606, the construction company must follow these five steps.

1.) Identify the contract with the customer

2.) Identify the performance obligations in the contract

3.) Determine the transaction price

4.) Allocate the transaction price to the performance obligations in the contract

5.) Recognize revenue when the entity satisfies a performance obligation.

The Cash Method

The simplest method for recognizing revenue is the cash method. Everything is based on its real-time impact on the company's cash. Contractors record revenue or expenses when and only when they receive payment. Therefore, there are no accounts payable (A/P) or accounts receivable (A/R). Under cash accounting, if money hasn't changed hands yet, there's no transaction to account for. The cash method of recognizing revenue has limitations. Though many small businesses in the U.S. use cash accounting, according to the IRS, only some contractors qualify to do so. Uncle Sam only allows some contractors with less than a set average annual revenue to use the cash method for tax purposes.

The Completed Contract Method

Under the completed contract method (CCM), expected income from a contract isn't reported until the project finishes and the same goes for the expenses. The date of completetion is spelled out in the contract and is often months or even years away from the date work begins. Everything hits the income statement once the contract is finished and any profit is not officially recognized until the end. Not every contractor can use CCM. The IRS imposes certain time and annual revenue limitations on the use of CCM. You can read more at https://www.irs.gov/pub/irs-utl/Construction_ATG.pdf

The Percentage of Completion Method

The percentage of completion method of accounting requires the reporting of revenues and expenses on a period-by-period basis, as determined by the percentage of the contract that has been fulfilled. As a project progresses toward completion, the contractor can bill for the work they've performed. In order to calculate how much of the contract they've earned for a billing period, they might choose among a number of methods, including cost-to-cost and estimated percent complete.

ASC 606 Revenue Recognition Standards

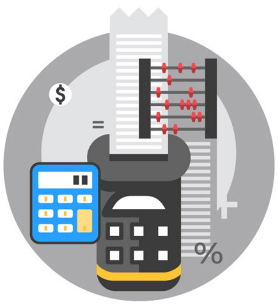
The Financial Accounting Standards Board, which oversees the U.S. generally accepted accounting principles (GAAP), issued "ASC 606: Revenue from Contracts with Customers" as a new set of standards for recognizing revenue. GAAP provides best-practice accounting standards across all U.S. industries. As of December 2018, all companies reporting under GAAP need to follow ASC 606. Private companies don't have a formal obligation to use GAAP, however many choose to follow its best practices.

Things to ask your Accountant

As you have gone through this eBook, you may be wondering whether your present accountant can help optimize your business. If that is the case, we suggest that you ask prospective accounting firms these questions:

How can you help my business?

An accountant should be able to help you determine areas of growth for your business. By providing insights on your cash flow patterns, inventory management, pricing and business financing.



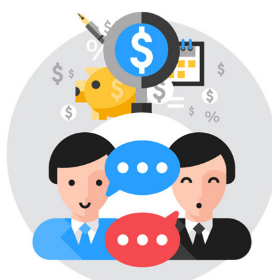
They should be able to help you create financial forecasts.

They should be able to work with you to create a business budget that will support your business goals?

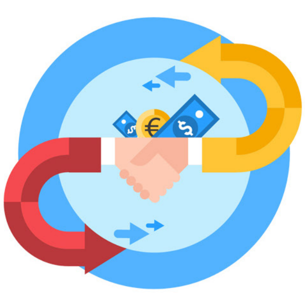
The big question to ask yourself: are they capable of becoming your trusted advisor?

How can you help my cash flow?

A good accountant will be able to help you sort through expenses that are not necessary to the firms performance. A great one should be able to identify weak areas such as cash flow. Help plan budgeting & contigencies.They should be leveraging their experience to help you grow your business.



Have you ever worked with a construction company before?



If your accountant hasn’t had previous experience with a contracting or construction firm, they might not be providing you the advice & service that your company needs. Construction accounting as you can see is complicated.

The accounting firm might be competent in many other areas, but you run the risk of missing out on the possible benefits of an experienced accountant.

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GET AN EXPERT IN CONSTRUCTION ACCOUNTING

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Specialized Construction Billing

Unlike other industries that operate around fixed-price or point of sale billing, the construction industry can use a number of billing styles depending on the kind of construction being done, the size of the contractor and the benefits to profitability. It practically becomes indispensable to partner with an accounting firm who is rooted in the intricacies of construction accounting. Let’s look at just a few contract types and billing formats.

Fixed Price

Also known as a lump-sum contract, fixed price billing is based on a detailed estimate that gives a total cost for the entire project. It can also be considered in two types: fixed-price hard bid and fixed-price negotiated. A hard bid essentially says, “No matter what, we’re building it for this amount of money.” As a result, the risk is heavily on the contractor rather than the owner. If there are any overruns because of changed site conditions, input costs, or just bad bid estimation, that falls on the contractor. A negotiated lump sum, on the other hand, might allow for some contingencies and unforeseen events. Billing a fixed-price contract often happens on a percentage-of-completion basis with retainage withheld.

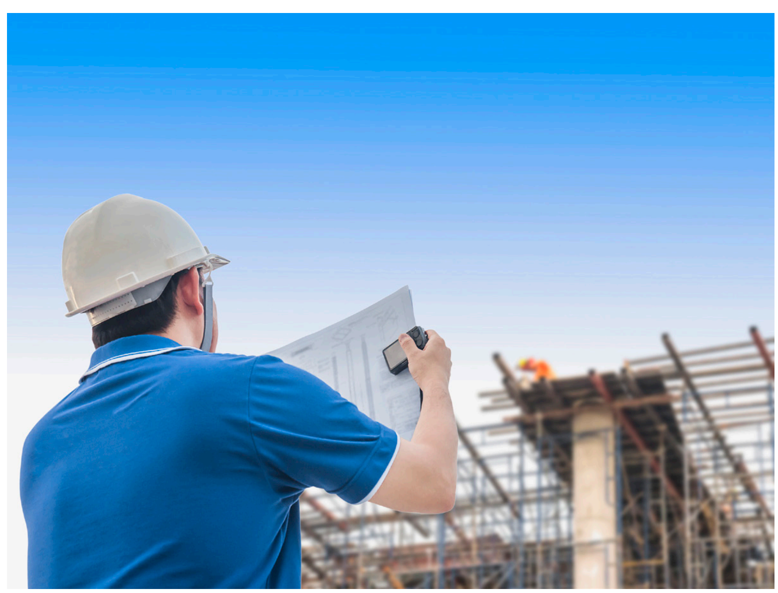
Time & Material

Time-and-material billing bases the contract price on a per-hour labor rate plus the cost of materials used. For both the labor and materials components, the contractor may apply a standard markup. This builds their profit percentage into the amount and accounts for the cost of overhead.
For example, a team of masons installing a foundation are paid $40 an hour per mason. That team of masons might be billed out at $90 an hour. This method of billing is also applied to materials like bricks and mortar or any additional item being added.

Unit Price

Under a unit-price contract, the contractor bills a customer at a fixed price-per-unit rate. Typically, this will be useful if they aren’t able to estimate the unit production for the project with any great certainty.

Unit-price billing is especially common among heavy-highway and utility construction companies. With unit price method, the risk tends to be shared between the contractor and customer, since production quantities can end up being higher than estimated.



AIA Progressive Billing

One common construction billing format is known as AIA progress billing, named after the American Institute of Architects that produces its official forms. As a type of progress billing, AIA billing invoices the customer based on the percentage of work completed for that billing period. This invoice (which is considered an application for payment) usually has a signed summary sheet, with a schedule of values that goes into the details of what has been finished to date. The recipient of the invoice can then go through it for accuracy and review. They can either accept it as is, ask questions about it prior to payment, or dispute the amount billed. If there are disagreements, they can send it back underlining the disputed charges where the contractor can revise and resubmit the AIA billing application.

Construction Payroll

Finally, with multiple profit centers and decentralized production, plus rigorous compliance requirements, the construction industry also sees some of the more unique and complex payrolls.
This is most true where there are:

1. prevailing wage requirements & certfied payroll reporting
2. multiple pay rates, multiple states & multiple localities
3. other compliance reporting.

Certified Payroll & Prevailing Wage

Contractors who work on government projects often have to adhere to the prevailing wage payroll rules, or “Davis-Bacon payroll” named after the landmark Davis-Bacon Act. Prevailing wage requirements demand that contractors pay the standard rate of compensation or “prevailing,” rate for each worker classification on similar jobs in the area. This is where contractors can’t even compete for public project work without a highly knowledgeable construction accountant like TYS LLP. Contractors must then certify their compliance on each project using certified payroll reports that vary between different states and/or agencies.

Construction Payroll (continued)

Though prevailing payroll sounds like the minimum wage for each speciality or worker classification it is far more complex. First off, prevailing wage payroll can include and may require non-cash compensation let's call those "fringe benefits," such as health care or continuing education. Secondly, the prevailing wage rate will vary not just by area but also specific worker classification. Each governmental jurisdiction can have unique determinations for what constitutes a job function and how it qualifies under which classification, plus the level of expertise or seniority. So a single employee might have multiple prevailing wage rates and fringe requirements on a single job depending on what they're doing each hour. These rates can also change every six months to a year. Yikes!

Union Payroll & Reporting

Union contractors face a similar situation as prevailing-wage contractors. Where certified payroll typically tracks wages and fringe benefit obligations for government agencies, union payroll needs to track and report wage and fringe obligations to the union's Local.

This becomes even more complicated with multi-union payroll. For example, a crew might have a home union but work on a project within another union Local's jurisdiction. In that case, the home Local might have a claim on health care contributions and pension deductions while the job Local wants dues and political action contributions. Each appropriate benefit and deduction would need to be split out to the right Local and reported appropriately.

Reporting requirements for a particular union may exist on a national or a local level. Contractors can typically determine their requirements, especially when entering another jurisdiction, by checking with their local union business manager.

Multiple Rates, States & Localities

As if it wasn't hard enough keeping track of huge variety of prevailing wage and union rates, if you are a contractor with multiple sites in multiple cities and states, you guessed it, you have to deal with multiple tax withholding all within a single payroll.

Multiple-site contractors in multiple jurisdictions have to watch out for double taxation. The problem arising from an employee who might reside in one state but work in another. When states have a reciprocity relationship, however, the worker's state of residence may issue a credit for taxes paid on income earned out of state.

That way, they don't pay twice, but this takes planning and requires careful attention to time cards and pay stubs. An expert construction accountant is really key here.

A construction company who has an employee working in multiple states has to watch for the hidden back-office expense of overpaying on unemployment tax. Unemployment is often owed only to one state per employee. If a mistake has been made by the contractor and they paid out to each state they worked in, good luck getting your money back, let alone get contacted by the states for a refund. In all fairness it's not the state's job, it is the contractor's and it's not always clear where unemployment tax should be paid. The Department of Labor suggests considering four factors in sequence:

- Are the services localized?
- Does the employee have a base of operations?
- Is there a place or direction of control?
- What is the employee's state of residence?

Compliance Reporting

Finally, even if the construction company doesn't have to file certified payroll, they still face a number of payroll reporting requirements. These can include union reports, workers' compensation, new-hire reporting and equal employment opportunity (EEO) compliance. Contractors need to have a keen awareness of these requirements for each jurisdiction they bid on and work in, from the federal down to the local level.

SURETY BONDING

For construction companies planning to take a loan from a bank or working on a government project, having a construction accounting expert who can perform a surety bond is of utmost importance. A surety bond acts as a guarantee that the construction company will perform the work as agreed upon in the contract. In case of any default, the surety bond protects the obligee, which can be the government or the bank, by reimbursing them for the losses incurred.

How Important is a Surety Bond in Construction Projects?

A surety bond is essential for any construction company that wants to take on a project with a government agency or obtain a loan from a bank. Having a surety bond shows that the construction company is financially stable and reliable, and it gives assurance to the obligee that the work will be performed as agreed upon in the contract.

Here are some of the reasons why a surety bond is crucial in construction projects:

1 - Provides financial security to the obligee - A surety bond protects the obligee from any financial losses that may arise due to the construction company's default. It gives the obligee peace of mind knowing that they will be reimbursed for any losses incurred.

2 - Ensures that the construction company fulfills the contract - A surety bond acts as a guarantee that the construction company will perform the work as agreed upon in the contract. This ensures that the obligee gets the work done as per the contract, and it gives assurance to the obligee that the project will be completed on time and within budget.

3 - Enhances the reputation of the construction company - Having a surety bond shows that the construction company is financially stable and reliable. This enhances the reputation of the construction company, making it more attractive to potential clients.

4 - Helps the construction company win contracts - Many government agencies and banks require a surety bond before awarding a contract. By having a surety bond, the construction company can increase its chances of winning contracts.

How Can a Construction Accounting Expert Help?

A construction accounting expert plays a crucial role in the surety bonding process. They can help construction companies navigate the complexities of the surety bonding process and ensure that they are in compliance with all the requirements. TYS is an expert in the field of construction accounting with real-world experience in surety bonding. Contact us today.

CONCLUSION

Construction accounting is complicated to say the least. A general accounting firm may be able to manage the basics for a small contractor, but a Construction Accounting Specialist should also be a trusted business advisor and strategic partner. Accounting is a powerful tool to drive business growth and provide competitive advantage.

If you feel you're not in the right hands, consider TYS, LLP, a new brand of accounting firm: collaborative, innovative and proactive. Our tactics and technology are backed by rock-solid knowledge and business instinct, vast reserves of experience with proven efficiency, and a commitment to "thinking forward" rather than scrambling behind, all for the benefit of our clients.

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Begin with the foundation - Keeping Track

Construction accounting categorizes every aspect of a customer's project. The list includes: service work, consulting, engineering, labor, design, physical products and materials, and more. It also accounts for vehicles and equipment, which may or may not be owned by the company as a fixed asset. This type of accounting requires invoicing and vendor payments and business owners must fully understand such concepts as job-codes, cost-codes, and milestone-based billing, draw contracts, change orders, hold-backs, etc.

Secondly and most important, successful, accurate accounting is centered on the ability to track, report and categorize costs and other expenses in your construction business. Having and then being able to utilize this data is essential for understanding how to bid on projects, which projects are profitable for your business, how to bill clients accurately and fairly, and how to make the most of your firm's resources. This done well becomes your company's competitive strength. Time, money and other resources are rarely wasted.

When you work with a reliable, public accounting firm with decades of experience in the construction market, you benefit from their ongoing contact with bankers, bonders, and law firms. They will be able to advise you on tax rules, compliance rules and the latest industry best practices that could impact the growth and reputation of your business.

TYS LLP has more than 60 years of combined experience in construction accounting and we can help get your business the help it needs to become more profitable and avoid any tax related issues that could pop up. TYS are experts in construction accounting and can help your company soar.

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