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Editorial Materials

Specialized Industries

Construction Contractors

Chapter 1 Industry Overview

100 Content and Organization of This Guide

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100.1 This *Guide* has been designed for use by both internal accountants and independent CPAs who serve the construction industry. The first two chapters are designed to provide an understanding of the construction industry, the types of contracting organizations, and the terms of contracts common to this industry. Chapter 3 addresses accounting and reporting requirements under generally accepted accounting principles, and Chapter 4 summarizes the complex tax issues faced by construction contractors. Chapters 5 and 6 explain auditing issues that are unique to the construction industry, and Chapter 7 discusses compilation and review services that practitioners often provide to construction contractors. Chapter 8 provides a high-level overview of general guidance that applies to most consulting services, as well as information on two particular consulting services that are commonly provided to construction contractors: financing services and claim settlement services.

100.2 Accountants who provide services to construction companies and are familiar with other PPC guides can be assured that the practical approach used by PPC has not been abandoned in *PPC's Guide to Construction Contractors*. This is especially true in Chapters 5 and 6 where the authors have leveraged certain information in *PPC's Guide to Audits of Nonpublic Companies* and tailored it specifically to address the unique problems, circumstances, and audit approaches common to the construction industry. In addition, the information contained in Chapter 7 has been adapted from *PPC's Guide to Compilation and Review Engagements*. The authors have also used this tailoring approach for the practice aids, where the checklists, letters, programs, and other practice aids found in *PPC's Guide to Audits of Nonpublic Companies* have been customized for a construction contractor client. The authors recommend that owners of *PPC's Guide to Construction Contractors* also maintain current editions of *PPC's Guide to Audits of Nonpublic Companies* and *PPC's Guide to Compilation and Review Engagements* because the guidance in each of these books complements and amplifies the others. [Those guides can be ordered from the Thomson Reuters website at tax.thomsonreuters.com or by calling (800) 431-9025.]

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101 Introduction

Scope of the Industry

101.1 The construction industry is one of the largest segments of the American economy. It employs more people, contributes more to the gross national product, and consumes more raw materials than any other single industry. Current statistics on new construction are available at www.census.gov/econ/. The thousands of companies that compete in this industry range in size and sophistication from the *father and son* remodelers who operate out of the back of their pickup trucks to multinational contractors who specialize in projects costing millions of dollars and employing hundreds—even thousands—of workers. This segment of the economy has also spawned related industries that would not exist if not for the construction industry. Companies that manufacture and deliver the raw materials used by contractors, provide financing for new projects, guarantee completion of projects by issuing various types of bonds, and provide a host of other services specifically to the construction industry, contribute to the prominence of this industry in the overall economy.

101.2 Unfortunately, there is also an unusually high rate of failure among construction contractors due to a number of factors. Some of the most common causes for the failure of construction contractors include:

- Periodic downturns in the overall economy.
- Subcontractor bankruptcy.
- Incompetence or lack of industry experience of the owners and key personnel.

- Loss of key personnel.
- Inability to adequately estimate project profitability.
- Problems obtaining information from the field and poor communications between the home office and the field.
- Outside owner investments that divert attention or profits from the contractor's operations.
- Expansion into new geographic areas.
- Expanding into new types or specialties of construction.
- No formal continuity plan.
- Expanding too quickly in volume or in project size.
- Insufficient billing procedures.
- Lack of an adequate accounting system.
- Significant debt.

101.3 Some of those factors cannot be controlled by a construction contractor, such as periodic downturns in the overall economy that may lead to higher than normal subcontractor and contractor business failures. Contractors can minimize the effect of other factors, however, if they exercise proper precautions. One of the most pervasive causes of failure among construction contractors is the inability of many contractors to properly manage the financial aspects of their businesses. The

construction industry is very competitive, with margins averaging as low as 2% for some segments of the industry. Thus, it is crucial for contractors to either thoroughly understand the financial aspects of their businesses or employ someone who does.

101.4 The Role of the Accountant

Contractors cannot successfully manage their businesses unless they have timely and accurate financial information about completed contracts and those in process. Some contractors employ in-house accountants, while others rely on accountants in public practice to provide financial information. Accountants in public practice provide a variety of tax, audit, compilation, review, and consulting services to clients in the construction industry. Regardless of whether the financial information is provided by internal accountants or CPAs in public practice, it must be complete, accurate, timely, and understandable to be of any use to the contractor.

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102 Participants in the Construction Industry

102.1 The construction industry has many participants, including owners, architects, engineers, contractors, subcontractors, construction managers, developer-contractors, suppliers, tradesmen, inspectors, and sureties. All of those participants play an important role in the *construction process*; however, the discussion that follows is limited to those who directly participate in the *contracting process*.

Owner

102.2 The owner, which may be a sole proprietor, partnership, corporation, or governmental unit, conceives and initiates the construction project. After obtaining the necessary financing, the owner contracts with others to design and build the structure. The owner has legal title to the project throughout the construction period (subject to liens normally filed by the financial institution that provides funding and the general and subcontractors who work on the project).

Design Professionals

102.3 The owner engages design professionals to design the structure to be built. They may be either architects or engineers. When the structure being designed is a building, the design professional will generally be an architect. When the structure is something other than a building (for example, a road or a bridge), the design professional will usually be an engineer.

Contractors

102.4 Depending on the type of work that contractors perform, they can be classified as highway, heavy construction, or general building contractors. The common broad characteristics of each of those types of contractors are described below.

102.5 Highway Contractors

Highway contractors are primarily involved with paving work and are engaged by owners to build

roads, streets, bridges, and airports. While most highway construction contractors provide services to a branch of the federal, state, county, or municipal government, these contractors may also work for independent private developers to build streets, curbs, gutters, and sidewalks for new commercial or residential developments.

102.6 Heavy Construction Contractors

This type of contractor is involved in large earth-moving projects and the building of foundations, dams, tunnels, bridges, and power plants. Typically, heavy construction contractors have a significant investment in equipment and employ hundreds of workers on each project. These contractors are normally very large companies with both domestic and international operations.

102.7 General Building Contractors

The largest category of contractor is the general building contractor. These contractors erect or remodel virtually every kind of residential, industrial, and commercial structure, including office buildings, manufacturing facilities, shopping centers, single family residences, apartment complexes, medical facilities, etc. General building contractors fall into the following two major categories:

a. *General Contractors*. By contract with the owner, general contractors are responsible for all of the work on a project. Generally, they subcontract out a substantial part of the work while maintaining overall control through project managers and on-site supervision.

b. *Subcontractors*. Subcontractors usually contract directly with the general contractor, but may contract with the owner or a developer-builder in certain situations. Subcontractors confine their work to a special facet of building (known as a *trade*), such as electrical, plumbing, HVAC (heating, ventilation, and air-conditioning), roofing, painting, glazing (glass work), drywall, carpeting, tile-setting, and other major construction components. Subcontractors often work for other subcontractors. For example, a sheet metal contractor may provide and install the metal duct work for the HVAC subcontractor.

Construction Manager

102.8 The construction manager is an agent of the owner and may be engaged in lieu of or in addition to a general contractor. As the owner's agent, the construction manager coordinates the construction project but has no contractual relationship with subcontractors and, generally, does not perform any construction work on the project.

Developer-contractor

102.9 The developer-contractor frequently has an agency relationship with the owner, much like the construction manager, but may have an ownership interest in the project under construction. In either

case, the developer-contractor offers a broader range of services than the construction manager. These services are described in detail in paragraph 103.19.

102.10 The roles of the participants in the construction industry, and their contractual relationships with each other under the various methods of project construction, are discussed in detail in the following section.

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103 Methods of Project Construction

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103.1 Because of the significance of the investment, the owner of a project normally has a strong incentive to complete the project as efficiently as possible. However, the nature of the construction process is complex and challenging for an owner to control. Materials must be purchased for the lowest cost from reliable vendors who can ensure delivery to the job site at the proper time. A delivery made too late can cause costly construction delays, while materials that arrive too early may be subject to theft, weather damage, or other loss. Skilled employees, such as architects, tradesmen, job site supervisors, and inspectors must be hired, and their efforts must be coordinated so they begin their part of the work at the proper times. It does no good for the roofer to arrive on the job site on the day the foundation is poured, nor should the drywall contractor start working before the electrician finishes wiring the building. Someone must work with the city zoning department and building inspectors, labor union representatives, and a host of other outsiders to ensure regulatory-compliant completion of the project. The construction process is so complex, it is little wonder that most owners choose to employ individuals who have considerable construction expertise to oversee the management of the project and ensure its timely completion.. The *expert* used most often is a general contractor.

103.2 A number of construction management methods have evolved to assist the owner in controlling a project. The following discussion of methods of project construction focuses on the general building contractor environment, including how general contractor service has evolved in the construction industry. Although this is generally similar to that of highway and heavy construction contractors, their size and the nature of their work may lead to differences. The reader should be alert to such differences and adapt the guidance accordingly.

Evolution of the Construction Industry

103.3 Traditional general contractors, or *Master Builders* as they were once called, were individuals or families who hired tradespeople, purchased materials, and undertook the construction process with their own resources and crews. They performed their own excavation, concrete work, carpentry, plastering, masonry, roofing, and interior finishes and hired subcontractors such as

plumbers, electricians, and other mechanical tradespeople. Usually, a community had only one or two general contractors. A general contractor would be hired directly by a project owner and would work directly with the owner's architect to construct a project.

103.4 With increasing activity, improved technology and methods, and the introduction of more general contractors, competition grew. A number of approaches to controlling construction projects have evolved over the years, with the following primary methods in use today:

- a. Traditional bid method.
- b. Construction management approach.
- c. Developer-contractor approach.
- d. Design-build method.

Traditional Bid Method

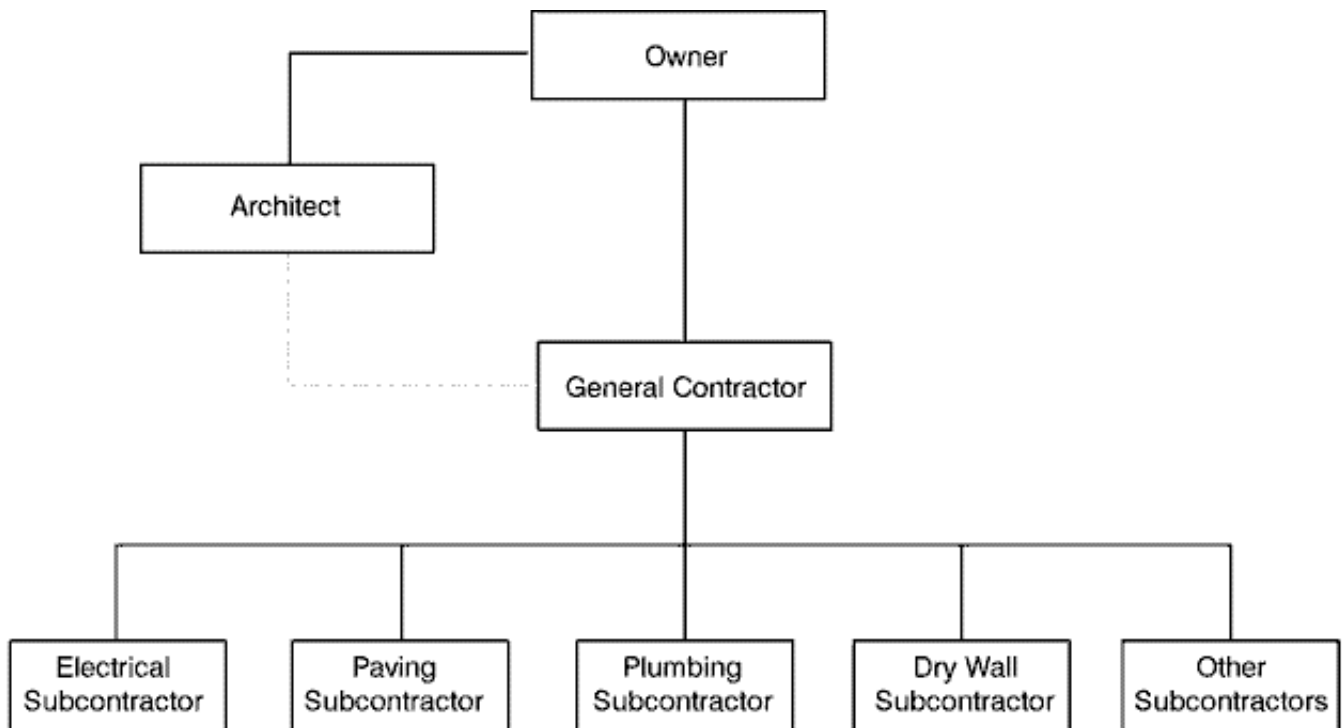
103.5 Description of the Traditional Bid Method

The traditional bid method (also known as the design-bid-build method) is still frequently used today. Under this method, the owner typically hires an architect or engineer to design a project. The design professional, with input from the owner, develops a project concept that is reduced to a set of plans and specifications. After the design has been totally completed, the plans and specifications are distributed to general contractors for competitive lump-sum bids. (Lump-sum contracts are discussed in section 202.) The owner generally awards the contract to either the lowest qualified bidder or the bidder who negotiated an arrangement that best suits the owner and provides the best value (which may not necessarily be the lowest bid). The bidder awarded the contract is responsible for purchasing the materials, hiring subcontractors and other specialists, coordinating the efforts of the construction team, and doing whatever is required to complete the project on time and within budget. When the traditional bid method is used, the owner contracts directly with the architect and the contractor.

103.6 As shown in Exhibit 1-1, there is no contractual relationship between the architect and the contractor, but the architect is expected to review and approve the work of the contractor. Also, the architect is often the referee when disputes arise regarding the contract or design document. The owner is responsible for the final selection of the contractor, the duration of the project, the approval of progress payments, extras or changes, and the final resolution of disputes or claims.

Exhibit 1-1

Relationships in the Traditional Bid Method



The owner generally hires the architect and the general contractor. The general contractor then hires the appropriate subcontractors.

103.7 Strengths and Weaknesses of the Traditional Bid Method

From the owner's perspective, the major strengths of the traditional bid method involve the ability to (a) establish or define the cost of the project early in the process and (b) assign much of the risk associated with the project to the contractor. However, these benefits may be largely offset by some inherent weaknesses in the method, such as—

- a. Overall project time is generally longer than for other methods because project design must be complete before bids can be taken and construction begun.
- b. Actual bids are sometimes greater than preliminary estimates by the design professional, requiring redesign to stay within budget and causing further delays.
- c. The conflicting motives of the contractor and the design professional increase the potential for contract claims. Whereas contractors are largely driven by the desire to minimize cost, design professionals tend to focus more on quality and aesthetics.

d. Although the owner may have awarded the contract to the general contractor with the lowest bid, the lowest cost may not be realized. The general contractor will usually place a contingency amount within the bid as a hedge against the risk of the unknown. If the unknown risk is not experienced, this contingency becomes additional profit to the contractor, *not* savings to the owner.

103.8 Risk of the Traditional Bid Method to the Contractor

Contractors usually obtain construction contracts through a competitive bidding process. Although this process reduces the risk of future price increases to the owner, it generally increases the risk to the contractor. Once a bid has been accepted by the owner, the contractor is expected to complete the project for the proposed price (subject to any change orders or extras as discussed in Chapter 2), even if the project costs the contractor more than anticipated.

103.9 In preparing a bid for a particular project, a general contractor must consider two conflicting factors: the cost of the project and the competitive nature of the bidding process. The contractor must price the bid at an amount that will allow for recovery of all costs incurred plus a profit. However, because an owner typically solicits bids from several general contractors, each contractor competes for the project. The amount of the bid will thus be the contractor's estimate of total costs plus a profit, with the total not to exceed the proposed amount of other bidders. Since the cost of the project is a relatively fixed amount for all bidders (that is, the plans and specifications require that certain materials be used, certain labor skills will be required, etc.), the difference between a winning and losing bid usually relates to the amount of profit the different bidders are willing to accept. Each bidder wants to win the contract with the lowest bid without *leaving any money on the table*.

103.10 Before general contractors submit bids to a project owner, they must develop a thorough understanding of the plans and specifications for the project. To ensure that the project can be completed at a profit, the general contractors must make sure that all costs are included in their estimates. Direct costs, such as materials, labor, and subcontract costs, can, in most cases, be accurately estimated and included. Other costs such as overhead and interest are less obvious but still must be considered.

103.11 The general contractor benefits by knowing who their competitors are before submitting their bid. If bidders are competing against firms with higher than normal overhead, they may be able to increase the profit factor in their proposals while still remaining competitive. On the other hand, many companies have a reputation for *low-balling* bids, that is, deliberately bidding lower than cost to get a job with the knowledge that they can turn a profit through change orders and extras during the project.

103.12 Accountants can provide invaluable assistance to contractors in the preparation of their bids. The accountant is often the only person who is aware of all direct and indirect costs that must be

recovered from a contract. Thus, the accountant needs to be involved in all phases of a contract, from the preparation of the initial bid through the completion of the project.

Construction Management Approach

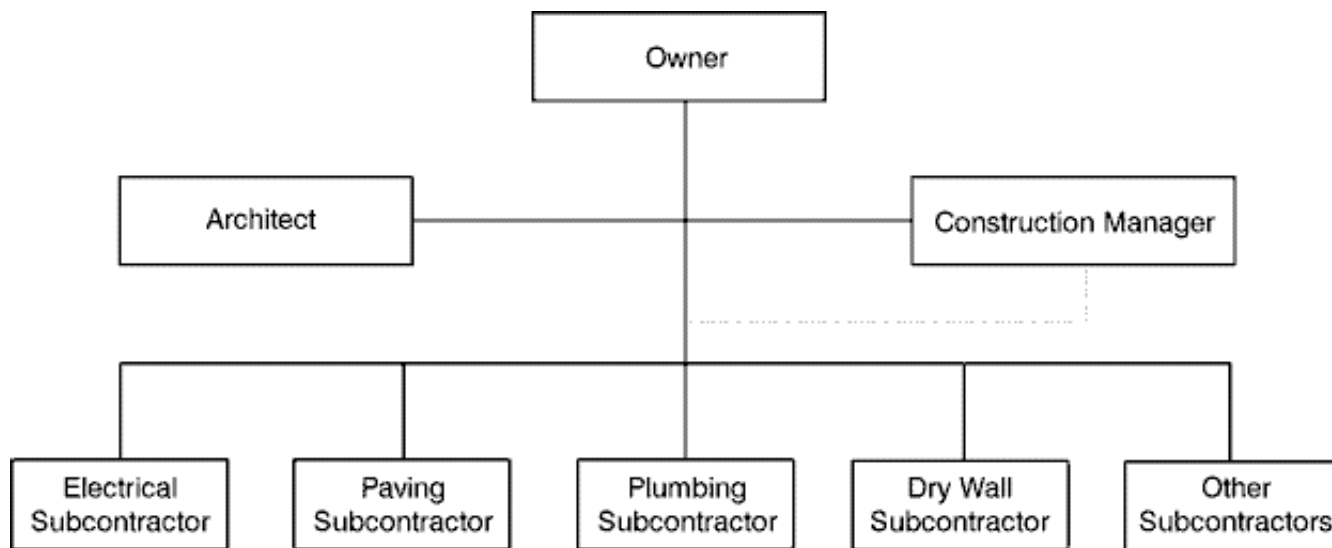
103.13 Description of the Construction Management Approach

Although still a very popular method of obtaining construction projects, the traditional bid method has shortcomings. During periods of inflation and/or rapidly increasing construction costs, it becomes difficult for contractors to realize their estimated profit under the traditional bid method on projects that take more than half a year to complete. Accordingly, the construction management approach is increasingly used if the timing of project completion is important.

103.14 The construction management approach introduced a professional consultant, the construction manager (CM), to the construction team. The CM gets involved in all phases of a project, usually taking the place of the traditional general contractor. The CM becomes an agent for the owner and controls the project from early design to move-in. The CM, generally a professional engineer, development firm, or architect by experience, assists the owner in evaluating financial feasibility, developing realistic budgets and schedules, and evaluating cost-effective solutions. The organizational structure for this construction method is shown in Exhibit 1-2.

Exhibit 1-2

Relationships in the Construction Management Method



With this method, the owner typically does not have a general contractor. Instead, the owner contracts directly with the individual subcontractors, whose work is overseen by the construction manager.

103.15 Although it will never replace the traditional bid method, construction management has

become a desired alternative especially during economic times such as those described in paragraph 103.13. Additionally, this approach is especially useful for larger, more complex projects that may be beyond the capabilities of most general contractors. Depending on the project size, the CM may recommend hiring individual subcontractors, project managers, and on-site supervisors to build the project. Alternatively, the CM may recommend hiring a general contractor who has an established set of subcontractors and the ability to provide job site management and supervision.

103.16 Strengths and Weaknesses of the Construction Management Approach

If project timing is of paramount importance, the construction management method facilitates a fast-track approach to building, whereby construction can be initiated before the total building plans are complete. Design then progresses just ahead of the various phases of construction. By overlapping the design and construction schedule, significant time can be saved and the overall design/construction schedule compressed. The result can be earlier completion and occupancy and less cost due to inflation or interest on funds applied. (For example, one month earlier completion at 9% interest on a \$5 million project saves an owner \$37,500.) Additionally, during periods of rapidly escalating construction costs, compressing the time required to complete the contract also produces savings.

103.17 When this approach is employed, there is a risk of cost overruns and unmet deadlines. Since construction often starts before the plans and specifications are complete, some procedures may need to be redone or may not have been required at all. Also, a CM will generally not provide the owner with the same degree of price protection as a general contractor. Under a lump-sum contract with a general contractor, an owner typically knows what the cost of the project will be before construction begins. This is generally not the case under the construction management approach.

Developer-contractor Approach

103.18 Description of the Developer-contractor Approach

A more-recent phenomenon has been the emergence of the developer-contractor approach to construction projects. The developer-contractor offers perhaps the most complete set of project or construction services available to an owner. Traditionally, the developer was an entrepreneur who conceived a construction project, built it, retained ownership, and leased it to others. Today, many developers form joint ventures with owners, who provide the necessary capital for a project, while the developer provides the expertise and manpower to create it. Normally, the developer is the majority partner in a venture. However, capital has become such a prized commodity that the financial partner is often the majority partner. Accordingly, many developers will contract with an owner on a fee basis to create a project.

103.19 Range of Developer-contractor Services

The developer-contractor, when engaged on a fee basis, functions much like the construction manager, that is, as an agent for the owner. In many cases, the developer is also the contractor, so the owner is provided even greater control over the design, cost, and schedule of a project. The

services provided by the developer-contractor generally include the following:

a. *Site Selection and Acquisition.* This activity includes analysis of alternative sites, market study and feasibility analysis, development of new streets if required, working with municipalities to accomplish rezoning, replatting, and bringing utilities to the site. This also includes contracting for the site with sufficient contingencies to make sure it can be properly developed to accommodate the intended project.

b. *Total Project Feasibility Analysis.* Besides an analysis of the building and construction costs, this will include such items as: costs of land closing and title work, interim and permanent financing costs, negative cash flow during absorption or lease-up period, leasing and finish-out costs for tenants, and a complete project cash flow projection.

c. *Ownership Structuring.* Sometimes the ownership structure is simple, with one or two owners, but larger projects often require complex structuring. In addition to the entrepreneur and the developer, ownership may include the lender or one or more major tenants of the prospective structure. Additionally, financing may require bringing in outside funding through private placement or public funding.

d. *Arrangement of Interim and Long-term Financing.* A good developer will have knowledge of sources of funds and a track record for bringing the most favorable funding to a project. This includes the interim funds required during the construction process and the long-term or mortgage funds needed upon completion of a project.

e. *Structuring a Lease Program for Projects That Have Speculative Space That Is Not Pre-leased by Tenants.* Frequently, the structures built using developer-contractors include excess capacity or speculative space to be leased by the owner. In these cases, the developer-contractor will usually have the knowledge and expertise to design a leasing program for the owner.

f. *Arranging and Contracting for Management of the Completed Project.* This includes such functions as the collection of rent, maintenance, landscaping, and garbage pickup.

103.20 The developer-contractor is sometimes referred to as a *package* builder, or *turn-key* contractor: one who is responsible for a project from conception to completion. As with the

construction manager, the developer-contractor is active throughout the design phase to ensure that the project can be completed with the available funds. The developer-contractor is also involved throughout the construction process to ensure its timely completion within budget.

Design-build Method

103.21 Description of the Design-build Method

Design-build is a construction project delivery method in which one entity, the design-build team, works under a single contract with the owner to provide design and construction services. Most often, a construction company combines with an architectural or engineering (A/E) firm to contract for a design-build project. The combination of the construction company and the A/E firm often occurs through a joint business venture, such as a joint venture, a corporation, or a limited liability company (although other business structures are also used). Given the amount of effort involved in forming a new business structure, this project delivery method is generally used for large construction projects. Additionally, it is not uncommon for the business structure to remain intact for more than one project.

103.22 Use of the design-build methodology has greatly accelerated since the early 1990's making it a significant trend in design and construction. A report released in 2011 indicated that design-build project delivery is now used for more than 40% of nonresidential construction projects.

103.23 Pros and Cons of the Design-build Method

The design-build method transforms the relationship between designers and builders, which is often adversarial in other construction methods, into an alliance that fosters collaboration and teamwork. That fundamental change allows work to be completed faster with fewer problems, and has resulted in far less litigation between the contractor and the A/E when the design-build method is used, as compared to other methods.

103.24 Additionally, an integrated team is more geared toward efficiency, innovation, and quality. The collaboration of the team often results in a better project than was initially imagined. Similar to the construction management approach, construction can be initiated before building design is complete, thereby allowing for faster completion of the project.

103.25 Due to the single point of responsibility for the project, risk is minimized for the project owner and the owner avoids being placed directly between the A/E and the contractor. The design-build method places the responsibility for design errors and omission on the design-builder, which is an advantage for the owner who is relieved of major legal and managerial responsibilities. However, the burden for those costs and associated risks is transferred to the design-build team.

103.26 While the design-build method has been used successfully for over two decades now, a few public scandals have created some concern about the use of this method. The concern has centered on the lack of competitive bidding, which may result in certain subjective decisions, including contractor and subcontractor selection. Additionally, the design and price selected may arouse public suspicion, which can lead to a loss of public confidence. Those issues have been more of a concern

for government-funded projects.

Summary

103.27 All of the approaches described in this chapter are successfully used in construction contracting today. The most appropriate method for any given project depends on its unique set of facts and circumstances. However, one generalization can safely be made: a properly drafted contract is a key ingredient to the success of any construction project regardless of the method employed. The elements of the various contract types are discussed in Chapter 2.

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104 Forms of Organization

104 Forms of Organization

104.1 Like other businesses, contractors may be organized in one of several different forms. The decision is often based on the contractor's overall objectives such as minimizing income taxes or limiting liability. Significant factors to consider include:

- Required financing.
- Whether income or a loss is expected in the near-term.
- Risk of significant liabilities resulting from the business.
- Whether capital will be needed.
- Tax consequences.
- The personal wealth of the owners.

This section discusses legal forms that construction contractors may take.

Sole Proprietorships

104.2 In a sole proprietorship, the business and assets are owned by a single individual. This form is

simple and can provide many tax advantages. However, it also has significant disadvantages. For example, proprietorships may have difficulties raising capital and they offer no liability protection to the owner. Nonetheless, many construction contractors are structured as sole proprietorships.

Corporations

104.3 A corporation is a separate legal entity, with title to the assets in the name of the corporation. Stockholder's voting rights are generally determined based on their percentage of voting common stock. Corporations can generally offer stockholders protection from personal liability, although lenders and sureties may circumvent this protection by requiring stockholders to personally guarantee loans to the corporation. Key disadvantages to construction contractors are the high cost of forming and maintaining a corporation.

104.4 Tax Considerations

The tax attributes of a corporation vary significantly depending on whether it is a C or an S corporation. Generally, a C corporation's earnings are taxed at corporate rates, losses generate tax benefits only to the extent they can be offset against corporate taxable income, and tax credits generate tax benefits only to the extent they can be offset against corporate taxes. There is no pass-through to the stockholders. Distributions of corporate earnings to stockholders are not deductible by the corporation, but they are taxable to the stockholders, thus effectively imposing a double tax on the distribution of earnings. For more detailed guidance, refer to *PPC's 1120 Deskbook* and *PPC's Tax Planning Guide—Closely Held Corporations*.

104.5 S corporations are pass-through entities; that is, profits, losses, and tax credits generally pass through to the stockholders in proportion to their ownership interests. Corporations that wish to elect S corporation status must meet certain IRS requirements, and there are limitations on the deductibility of S corporation losses by stockholders. For more detailed guidance, refer to *PPC's 1120S Deskbook* and *PPC's Tax Planning Guide—S Corporations*.

Noncorporate Ventures

104.6 Partnerships

A partnership is also a separate legal entity, with title to the assets of the business held in its name. There are two types of partnerships—

- *General Partnership*. In a general partnership, each partner is a general partner and has unlimited liability.
- *Limited Partnership*. In a limited partnership, at least one partner (the general partner) has unlimited liability, and the remaining partners are limited partners whose direct liability is usually limited to their capital investment.

Individuals, corporations, and other partnerships can be general or limited partners.

104.7 The formation of a partnership usually requires preparation of a partnership agreement that sets forth the rights and obligations of each partner. The following are examples of matters that are typically discussed in a partnership agreement:

a. *Allocation of Profits and Losses.* Profits and losses may be allocated differently from the proportion of contributed capital. Also, the allocations may vary depending on the source of the profit or loss. For example, contractor partnerships that also perform design services may allocate construction operating profits and losses differently from profits and losses on the design services.

b. *Transfer of Partnership Interests.* Ordinarily, general partnership interests can be transferred only with the approval of the other general partners. In a limited partnership, approval of one or more limited partners also may be required. On the other hand, the transfer of a limited partner's interest typically does not require approval by the other limited partners, but it may require the approval of one or more of the general partners.

c. *Designation of Managing Partner.* The partnership agreement normally designates one of the general partners as the managing partner and specifies the managing partner's powers and responsibilities.

104.8 The managing partner's ability to control partnership activities is usually limited. The following are examples of such limitations:

a. The managing general partner may be provided responsibility for day-to-day operations but be required to consult with the other general partners, and perhaps with one of the limited partners, on decisions regarding the bid amount for potentially significant contracts.

b. The managing partner may be given control, but a limited partner may have the ability to replace the managing partner.

104.9 **Taxation of Partnerships**

Income, losses, and tax credits from the partnership generally pass through to the partners in the proportion specified in the partnership agreement. Income is therefore taxed at individual rates, and

tax credits reduce individual income taxes. However, the deduction of losses generally may be limited based on the partner's activities and the extent and nature of the partnership interests. For more detailed guidance, refer to *PPC's 1065 Deskbook* and *PPC's Tax Planning Guide—Partnerships*.

104.10 **Undivided Interests**

Undivided interests are another form of noncorporate construction ventures, though less common than partnerships. In an undivided interest arrangement, the investors have joint title to the venture's assets and liabilities, and operations are shared to the extent of each investor's interest. Investors may have joint or several liability, depending on the obligation. There are two primary types of undivided interest arrangements:

- Tenancy in common.

- Joint tenancy.

104.11 The primary difference between the two arrangements is in the right of survivorship of the investors' interests. In tenancy in common, if an investor dies, that ownership interest is passed to the heirs. In joint tenancy, the ownership interest passes to the other investors. Other differences may also exist depending on the applicable state law.

Limited Liability Companies

104.12 Limited liability companies (LLCs) are a creation of state law. Each state establishes its own LLC rules and characteristics. Generally, an LLC is an entity (owned by members) with the corporate characteristic of limited liability for its owners, and certain partnership characteristics. These include the lack of continuity of life and limits on transferability of interests. Also, unlike a limited partner in a partnership, a member of an LLC can participate in its management.

104.13 **General Tax Treatment**

The attractiveness of LLCs depends on their treatment as partnerships for federal income tax purposes. The IRS has issued numerous IRS revenue rulings and private letter rulings relating to the tax consequences of operating as an LLC, but some LLC tax issues have not been resolved. For more detailed tax guidance, refer to *PPC's Guide to Limited Liability Companies*.

104.14 **Liability Considerations**

Because the LLC laws are not uniform among the states, each state law must be separately reviewed to determine what types of liabilities (for example, malpractice by another member, torts, general creditor claims) the members will be protected against.

104.15 Accounting for LLCs

While LLCs are unique legal entities, they do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. FASB ASC 272-10, *Limited Liability Entities*, provides guidance on applying existing accounting literature to LLCs. The guidance does not impose any new accounting requirements.

Other Contractor Considerations

104.16 Contractors have some unique considerations in deciding on the form of organization to use. The following highlights a couple of those considerations:

- It may be more difficult to get surety bond coverage if a contractor is formed as an S corporation or an LLC. Sureties generally favor a C corporation entity because the IRS monitors compensation levels to owners and the earnings accumulated in C corporations are beneficial to the surety.
- Construction contractors can operate as an LLC, but not all businesses can. A contractor should consider all the types of business it plans to conduct to determine if the LLC form can accommodate those plans.

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Accounting, Audit & Corporate Finance Library

Editorial Materials

Specialized Industries

Construction Contractors

Chapter 1 Industry Overview

105 Investments in Joint Ventures

105 Investments in Joint Ventures

105.1 By combining resources with one or more other contractors, a contractor may be able to bid and complete larger, more complex construction projects. Contractors may also move into other geographic areas by forming joint ventures with contractors in those areas. Some joint ventures are designed and created for bidding, negotiating, and performing one specific project. Other ventures are created to be permanent. The purpose of these permanent joint ventures is generally to pool resources and to bid on all contracts of a specific type for an indefinite period of time.

105.2 Joint ventures may take any of the forms of organization described in section 104, depending on the overall objectives of the joint venture and the venture participants.

105.3 Regardless of the form of ownership, the venture participants should prepare a written joint venture agreement. While the specific provisions of joint venture agreements may differ, the following items are usually addressed in each agreement:

- A statement of the venture's purpose.
- The capital contributions to be made by each participant, such as cash, equipment, etc.
- The rights and responsibilities of each participant.
- The bonding responsibility, if any, of each participant.
- How profits and losses will be shared.

- How decisions will be made.
- How the joint venture may be terminated.
- Default provisions and remedies for default.

Advantages and Disadvantages of Joint Ventures

105.4 Why do contractors turn to the joint venture form of operations? Two of the more important reasons relate to the financing of a project and the ability to spread the risk among two or more contractors.

105.5 Financing

Often projects are beyond the financial capabilities (both bonding and working capital) of a single contractor. A joint venture may be formed to reduce the level of an individual participant's investment to a manageable level.

105.6 Spreading of Risk

A joint venture provides an opportunity for two or more contractors to participate in large projects. The financial and other risks of these projects are shared by all participants. Such an arrangement allows a contractor to participate in projects that might otherwise be beyond the entity's ability.

105.7 Disadvantages

The primary disadvantage faced by participants in a joint venture is loss of control. A contractor may be accustomed to managing the operations without help from other parties. However, a contractor that is a partner in a joint venture must consider the interests of the other venture partners. In fact, important decisions are often the result of compromise among all partners in a joint venture. The unwillingness to compromise is a major reason for joint venture failures. Accordingly, a well-written and comprehensive joint venture agreement, as discussed in paragraph 105.3, is very important.

Accounting for Investments in Joint Ventures

105.8 The accounting methods normally used to account for investments in joint venture activities include (a) consolidation, (b) variable interest entities, (c) equity method, including the expanded equity method, (d) cost method, and (e) prorata combination. These methods are further discussed in section 308.

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Editorial Materials

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Chapter 1 Industry Overview

106 Services Provided by CPAs

106 Services Provided by CPAs

Traditional Services

106.1 Traditional services that CPAs in public practice typically provide construction contractors include:

- Bookkeeping/accounting.
- Compilation or review of interim financial statements.
- Compilation, review, or audit of annual financial statements.
- Review of interim financial information.
- Tax planning and return preparation.

CPAs also perform a wide variety of consulting services.

106.2 Very few contractors actually keep their books on a basis that is acceptable for either GAAP or tax purposes. This is true not only of most small contractors, but of many larger contractors as well.

106.3 Before a CPA can prepare a contractor's tax return; compile, review, or audit its financial statements; or provide any other accounting type services for a construction contractor, the

practitioner must first adjust the contractor's books to the appropriate basis. Doing so may represent nonattest services to which the ethics provisions of the AICPA *Code of Professional Conduct* (the Code), *Nonattest Services* (ET 1.295), apply. Accountants performing any nonattest services for attest clients should comply with the requirements of ET 1.295, which is discussed further beginning at paragraph 106.23.

106.4 Adjusting a contractor's books to the appropriate basis normally involves three steps:

- a. Determine how the activity should be recorded for the applicable financial reporting framework (such as GAAP or the tax basis, for example).

- b. Determine how the contractor is currently recording contract-related activity.

- c. Propose the necessary accounting adjustments.

106.5 The three most important contract-related activities that need to be adjusted are contract costs, progress billings, and revenues.

- a. Contract costs consist of direct costs, such as materials, labor, and subcontractor charges, and indirect costs, which are primarily overhead costs. In addition, for both GAAP and certain other financial reporting frameworks, capitalization of construction period interest may be necessary.

- b. Progress billings should be recorded in the balance sheet as a reduction of the contracts in progress account as they are rendered.

- c. For GAAP purposes, there are two methods of recognizing revenues: ¹

(1) Under the percentage-of-completion method, contract revenues and the related costs are recognized in each accounting period as a contract progresses toward completion.

(2) Under the completed-contract method, contract revenues and costs are not recognized until a project is substantially complete.

106.6 Typically these three activities, in particular contract costs and revenues, are not recorded correctly. Two of the methods typically used by contractors to account for contract activities are discussed beginning in paragraph 302.17.

Third Party Users

106.7 Annual financial statements are required to satisfy needs of third party users, including the following:

- Surety bond underwriters.

- State contract licensing agencies.

- Other governmental agencies.

- Banks providing construction financing.

- Suppliers and subcontractors.

- Project owners (customers).

Level of Services

106.8 The level of service to be performed on the financial statements by CPAs in public practice will depend on several factors, the more important of which are the following:

- The needs of third parties who will use the financial statements.

- The cost of the engagement relative to other alternatives.

- The CPA's independence.

- The CPA's ability to perform the required service.

106.9 The needs of third parties often dictate the level of service the CPA will provide. Although compiled financial statements are usually sufficient for internal use, many third party users want as much assurance as they can get. They usually require at least reviewed, and often audited, financial statements from contractors.

106.10 **Surety Underwriters**

Surety bonds are often required before submitting bids on projects. The surety underwriters may insist on the financial statements being audited, depending on the size of the proposed project and the financial strength of the company. In some instances, the surety company may accept reviewed or compiled financial statements. Surety bonds are discussed further beginning at paragraph 203.11 and in section 204.

106.11 **Contractor Licenses**

Contractors in many states are required to have contractor licenses before they are permitted to bid on construction projects. The requirements vary by state. Some states require licenses for all contractors, whereas other states limit licensing requirements to those with projects over stipulated amounts or certain types of projects. Some licenses are annual, some are by contract, and some are biennial. Local licensing authorities can furnish the requirements in specific states and local areas.

106.12 Some governmental agencies (such as state highway departments) require contractors to file prequalification reports to qualify for bidding on work for the agency. The contractor license applications and prequalification filings frequently are preprinted forms that include both an accountant's report and financial information. Typically, the financial information consists of a balance sheet and accompanying schedules. However, the forms may require full financial statements or require that financial information be attached.

106.13 Generally, the size of the contracts on which the license will permit the contractor to bid determines whether the entity's financial information must be audited, reviewed, or compiled. Such parameters are set by state licensing boards and governmental agencies.

106.14 **Lending Institutions**

Lending institutions may allow the contractor to have a larger unsecured line of credit if the financial statements are audited or reviewed.

106.15 **Cost of the Engagement**

An audit report is the highest level of assurance a CPA can provide on financial statements. But it is also the most expensive. A review report provides less assurance than an audit, but also requires less work by the CPA, resulting in a lower fee. A compilation report provides no assurance about the fairness of financial statements, and therefore costs less than a review or an audit. The cost of an audit is often more than twice the cost of a review.

106.16 The cost of converting a construction contractor's financial records to the appropriate financial reporting framework may be substantial. That cost will very likely be the same regardless of the level of reporting. The CPA should carefully consider the client's needs and the expected benefits of the report before suggesting a level of service.

AICPA Revised Code of Conduct

106.17 In May 2014, the AICPA issued a revised *Code of Professional Conduct*. The Code was effective on December 15, 2014, with the exception of the two broad conceptual frameworks: one for members in public practice and one for members in business, that will be given a one year delayed effective date. The Code is divided into three parts that separately apply to members in public practice, members in business, and other members (such as retired and unemployed members), as well as a preface that applies to all members. The Code also establishes a new numbering system with the reference preface of "ET." In addition, the Code provides conceptual frameworks that set forth requirements in those situations where the member has identified a threat to compliance with the rules in the Code and the relationship or circumstance creating the threat is not covered within the Code. As noted previously, the conceptual framework guidance is not effective until December 15, 2015, but early implementation is allowed.

106.18 *Conceptual Framework for Members in Public Practice*

As mentioned in paragraph 106.17, the Code includes two new conceptual frameworks: one for members in public practice and one for members in business, both of which are effective on December 15, 2015. Although the ethics guidance in the Code addresses many situations, that guidance cannot address all relationships or circumstances that may arise. When there is not an interpretation of the Code that addresses a member's particular relationship or circumstance, the *Conceptual Framework for Members in Public Practice* (ET 1.000.010) should be used to identify threats to a member's compliance with the Rules of the Code and to evaluate identified threats, both individually and in the aggregate. When using the conceptual framework, the member should evaluate whether the relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is an unacceptable threat to the member's compliance with the Rules of the Code. The *Conceptual Framework for Members in Public Practice* provides overarching guidance for Part 1 of the Code. (Part 1 of the Code is applicable only to members in public practice.) In fact, every topic in Part 1 of the Code requires that members apply the new conceptual framework in the absence of an interpretation that addresses the particular relationship or circumstance. [Under the *Independence Rule* (ET 1.200.001), members are required to apply the *Conceptual Framework for Independence* (see the discussion in paragraph 106.21) instead of the *Conceptual Framework for Members in Public Practice*.]

106.19 *Conceptual Framework for Members in Business.*

Similar concepts to the *Conceptual Framework for Members in Public Practice* apply to members in business under the *Conceptual Framework for Members in Business*. The Code defines a *member in business* as a member in industry, the public sector, education, the not-for-profit sector, and regulatory or professional bodies, who is employed (or engaged) contractually or on a volunteer basis. A member engaged in public practice is not considered a member in business. Part 2 of the Code provides the ethics guidance for members in business.

Independence ²

106.20 A CPA who is not independent with respect to a contractor client may not issue an audit or a review report on the contractor's financial statements. A CPA may, however, issue a compilation report (modified for this lack of independence) regardless of any independence conflicts. The CPA's independence, therefore, has a significant impact on the level of service provided for a contractor. However, none of the rules, interpretations, or other guidance of the Code deals with situations specifically involving contractors. Yet certain unique situations can arise in practice. For example, would an auditor be independent of a contractor if the contractor was building the auditor's home or an office building in which the auditor or the auditor's firm had a financial interest? Normally an auditor may purchase a client's product without being concerned about an impairment of independence. However, a construction contract extends over a relatively long period rather than being confined to an exchange at a particular date. During this period, the auditor and the contractor are in a business relationship that may be material to one or both parties. The Code does not address this specific issue, but neither does it prohibit all possible business relationships with clients.

106.21 The *Conceptual Framework for Independence* (ET 1.210.010), applicable only to AICPA members in public practice, should be used when making independence decisions on independence matters that are not explicitly addressed in the Code. When there is not an independence interpretation that is applicable to a particular relationship or circumstance, the member should evaluate whether the relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant facts to conclude that there is a threat to the member's and/or firm's independence that is not at an acceptable level. All such threats must be eliminated or reduced to an acceptable level in order for the member to be independent. In other words, a member's relationship with a client is evaluated to determine whether it presents an unacceptable risk to independence. If a relationship would compromise the member's professional judgment when rendering an attest service, the risk is unacceptable. The risk is also unacceptable if an informed third party having knowledge of all relevant information would perceive the relationship to be compromising.

106.22 For the practitioner to remain independent in the situation described in paragraph 106.20, the authors believe the contract should not be material to either party; the contract should not involve any terms or concessions different from contracts ordinarily entered into by the contractor; financing for the construction should be provided by an independent lender, that is, the auditor should not be a debtor of the contractor; and there should be no claims or disputes involving the contract. As a practical matter, where small contractors and/or small accounting firms are involved, the amounts will

generally be material to one or both parties. However, accountants should use professional judgment to determine whether their independence is at risk in a situation not explicitly addressed by the Code.

³ If a claim or dispute arises between the practitioner and the client, the Code at ET 1.290.010, *Actual or Threatened Litigation*, provides guidance on when independence may be impaired.

106.23 **Nonattest Services**

For many nonpublic engagements, the most frequent concern about meeting independence requirements is the effect of providing nonattest services, such as bookkeeping services, to the client. For example, a CPA may be asked to provide manual or automated bookkeeping services to clients who are too small to employ an adequate accounting staff, and, as previously mentioned, many construction contractor entities need assistance in adjusting their financial information before it is in compliance with the applicable financial reporting framework. Concerns may arise that an auditor's independence has been impaired in these circumstances.

106.24 According to ET 1.295 of the Code, before auditors perform nonattest services, they should determine that the requirements of ET 1.295 have been met. ET 1.295.040 requires the following with respect to the performance of nonattest services:

- The CPA should not assume management responsibilities for the attest client.

- The client must agree to perform certain specific functions in connection with the nonattest services.

- The CPA should establish and document in writing the understanding with the client regarding the nonattest services.

Those requirements are discussed further beginning at paragraph 106.28.

106.25 If the requirements of ET 1.295 have not been met during the period of the attest engagement or the period covered by the financial statements, independence is considered impaired *unless, for nonattest services performed during the period covered by the financial statements—*

- a. the nonattest services were provided before the period of the professional engagement (which begins when a member either signs an engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier),

- b. the nonattest services related to periods before the period covered by the financial statements, and

c. another firm performed the attest services on the financial statements for the period to which the nonattest services relate.

106.26 Although performing an individual nonattest service might not impair independence, the cumulative effect of multiple nonattest services can increase the significance of threats to independence. As discussed in ET 1.295.020, before agreeing to perform the services, the member should evaluate whether the aggregate effect of performing multiple nonattest services results in a significant threat to independence that cannot be reduced to an acceptable level by the application of safeguards.⁴ If no safeguards exist that eliminate the threat or reduce it to an acceptable level, the member's independence would be impaired. It is not necessary to consider threats that might be created when other network firms within the member's firm's network provide nonattest services.

106.27 During an attest engagement, the CPA will often communicate with management about issues related to the engagement. The following discussions are considered a normal part of an attest engagement and would not be subject to ET 1.295:

- The client's selection and application of accounting standards or policies and financial statement disclosure requirements.
- Whether the client's accounting and financial reporting methods are appropriate.
- Adjusting journal entries proposed by the CPA.
- The form or content of the financial statements.

The CPA is cautioned to consider whether the level of involvement constitutes a separate nonattest service. For example, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of an attest engagement and are, instead, nonattest services.⁵ However, such activities would not impair independence provided the requirements of ET 1.295 are met.

106.28 Under ET 1.295.030, independence is considered to be impaired if an accountant (or his or her firm) assumes management responsibilities for an attest client. However, the accountant may assist management in those responsibilities. For the accountant to remain independent, before the start of the nonattest engagement, the attest client and its management should agree to perform all of

the following functions in connection with the nonattest services (ET 1.295.040):

- Assume all management responsibilities.
- Oversee the services by designating an individual, preferably within senior management, who has suitable skill, knowledge, or experience.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.

106.29 In addition, the practitioner should be satisfied that management will be able to meet all of these criteria, make an informed judgment on the results of the nonattest services, and be responsible for making the significant judgments and decisions that are management's responsibility. In cases where the attest client is unable or unwilling to assume its responsibilities, the practitioner's performance of the nonattest services would impair independence.

106.30 ET 1.295.040 also requires the practitioner to *establish* and *document in writing* before performing the nonattest service, his or her understanding with the client regarding the following:

- Objectives of the engagement (i.e., the nonattest services).
- Services to be performed.
- Client's acceptance of its responsibilities.
- Practitioner's responsibilities.
- Any limitations of the engagement.

106.31 ET 1.295 does not specify how the understanding is to be documented, so the practitioner has flexibility. For example, the understanding might be documented in a separate engagement letter,

⁶ in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an attest engagement. The authors believe it is common in many contractor attest engagements for practitioners to also provide nonattest services, such as tax return preparation or bookkeeping services. The practitioner may choose to document the understanding with the client about the performance of nonattest services in the checklist at CNC-CX-1.2.

106.32 Certain activities performed as part of a nonattest service are considered to be management responsibilities and, therefore, impair independence regardless of whether the practitioner complies with the other requirements of ET 1.295. In addition, if a CPA assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. ET 1.295 identifies common nonattest service activities and provides guidance on considerations as to whether they impair independence. ET 1.295.030 specifically states that performance of the following activities would be considered a management responsibility, and would therefore impair a CPA's independence (that is, they would preclude the CPA from being independent):

- Setting policies or strategic direction for the client.

- Directing or accepting responsibility for the actions of the client's employees, except to the extent permitted when using internal auditors.

- Exercising authority on behalf of a client, such as authorizing, executing, or consummating transactions, or having the authority to do so.

- Preparing source documents, in electronic or other form, that evidences the occurrence of a transaction.

- Having custody of client assets.

- Deciding which of the accountant's or other third parties' recommendations to implement or prioritize.

- Reporting to those charged with governance on behalf of management.

- Serving as a client's stock transfer or escrow agent, registrar, or general counsel, or its equivalent.
- Accepting responsibility for the management of a client's project.
- Accepting responsibility for the preparation and fair presentation of the client's financial statements.
- Accepting responsibility for designing, implementing, or maintaining internal controls.
- Performing ongoing evaluations of the client's internal control as part of its monitoring activities.

106.33 Exhibit 1-3 provides a table that lists various types of nonattest services a CPA may commonly perform for a construction contractor and addresses the impact of those services on the CPA's independence. The *Nonattest Services* interpretation of the Code (ET 1.295) provides similar information about other types of nonattest services.

Exhibit 1-3

Impact on Independence of Performance of Nonattest Services

Type of Nonattest Service	Independence Would Not Be Impaired ^a	Independence Would Be Impaired
Bookkeeping, payroll, and other disbursements (ET 1.295.120)	<ul style="list-style-type: none"> • Record transactions for which management has determined or approved the appropriate account classification, or post client-coded transactions to an attest client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client-approved entries to an attest client's trial balance. • Prepare a reconciliation (for example, bank, accounts receivable) that identifies reconciling items for the client's evaluation. • Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the attest client provided 	<ul style="list-style-type: none"> • Determine or change journal entries, account codings or classification for transactions, or other accounting records without the attest client's approval. • Authorize or approve transactions. • Prepare source documents. • Change source documents without the attest client's approval. • Accept responsibility to authorize payment of attest client funds, electronically or otherwise, except as specifically provided for with respect to

the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

- Generate unsigned checks using source documents or other records provided and approved by the attest client.
- Process payroll using payroll time records provided and approved by the attest client.

• Transmit client-approved payroll or other disbursement information to a financial institution, provided the client has reviewed the information, authorized the member to make the transmission, and made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.

Corporate finance consulting (ET 1.295.130)

- Assist in developing corporate strategies.
- Assist in identifying or introducing the attest client to possible sources of capital that meet the client's specifications or criteria.
- Assist the attest client in analyzing the effects of proposed transactions, including providing advice during negotiations with potential buyers, sellers, or capital sources.
- Assist in drafting an offering document or memorandum.
- Participate in transaction negotiations in an advisory capacity.
- Be named as a financial advisor in a private placement memoranda or offering documents.

Information systems— design, implementation, or integration (ET 1.295.145)

- Install or integrate an attest client's financial information system, that was not designed or developed by the member (for example, an off-the-shelf accounting package).
- Assist in setting up the chart of accounts and financial statement format for an attest client's financial information system.
- Design, develop, install, or integrate an information system that is not related to the financial statements or accounting records.
- Train and instruct an attest client's employees on an information and control system.
- At management's request, perform routine network maintenance, such as updating virus protection, applying updates and patches, or configuring user settings.

Tax services (ET 1.295.160)

- Prepare a tax return and transmit the tax return and related payment to a taxing authority in paper or electronic form, provided that (a) the member does not have custody or control over the attest client's funds or assets and (b) the individual designated by the client to oversee the tax services reviews and approves the tax return and related payment and signs the tax return prior to member transmission.

electronic payroll tax payments.

- Accept responsibility to sign or cosign attest client checks, even in an emergency situation.
- Maintain an attest client's bank account or otherwise have custody of the client's funds or make credit or banking decisions for the client.
- Approve vendor invoices for payment.

- Commit the attest client to the terms of a transaction or consummate a transaction on the client's behalf.
- Act as a promoter underwriter, broker-dealer, or guarantor of an attest client's securities, or distributor of private placement memoranda or offering documents.
- Have custody of an attest client's securities.

- Design or develop a financial information system for an attest client.
- Make other than insignificant modifications to source code underlying an existing financial information system.
- Supervise attest client personnel in the daily operation of the information system.
- Operate an attest client's local area network (LAN) system.

- Represent an attest client in a court to resolve a tax dispute.

- Sign and file a tax return on behalf of management, provided that the member has the legal authority to do so and the taxing authority has prescribed procedures in place to permit a member to sign and file a tax return on its behalf (for example, Forms 8879 or 8453), and such procedures meet standards for electronic return originators and officers outlined in Form 8879; or an individual in management who is authorized to sign and file the tax return provides the member with a signed statement that clearly identifies the return being filed, and represents that the individual (a) is authorized to sign and file the tax return; (b) has reviewed the tax return, including accompanying schedules and statements, and it is true, correct, and complete to the best of the individual's knowledge and belief; and (c) authorizes the member or another named individual in the member's firm to sign and file the tax return on the client's behalf.
- Serve as the attest client's authorized representative in administrative proceedings before a taxing authority, provided that the client's agreement is obtained prior to committing to a specific resolution with the taxing authority.
- Use an attest client's power of attorney that is limited strictly to tax matters and does not bind the client to any agreement with a taxing authority or other regulatory agency.

Notes:

^a When performing these services, independence would not be impaired if the requirements of ET 1.295 are met. See discussion of those requirements beginning at paragraph 106.23

106.34 Should Proposing Journal Entries and Preparing Financial Statements in Connection with an Attest Engagement Be Viewed as Bookkeeping and, Therefore, Nonattest Services?

Paragraph 106.27 discusses revisions to ET 1.295 that make activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations outside the scope of the attest engagement, and therefore nonattest services that are subject to the general requirements of ET 1.295. ET 1.295 includes bookkeeping as an example of a nonattest service. Rather than define bookkeeping, ET 1.295 provides several examples of services that would be considered bookkeeping. Two of those examples, which are listed in Exhibit 1-3, are (a) proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the attest client and (b) preparing financial statements based on information in the trial balance. As a practical matter, small and midsize nonpublic contractors typically view proposing journal entries and preparing financial statements as part of the attest engagement. As discussed previously, revisions

to ET 1.295 consider activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations outside the scope of the attest engagement and subject to the general requirements of ET 1.295.⁷

106.35 For engagements covering periods beginning before December 15, 2014, the authors believe performing procedures in connection with an audit that are designed to address audit risk arising from the lack of control activities, such as reconciling carrying amounts of assets and liabilities with amounts reported by third parties, would not be considered bookkeeping services. Similarly, preparing financial statements as part of an attest engagement would not be considered a bookkeeping service. Neither of those services involves processing the entity's transactions or preparing its accounting records.⁸

106.36 Proposing adjustments of an entity's accounting records in connection with an attest engagement also would not be considered a bookkeeping service. To illustrate, assume that as part of an audit of the contractor's financial statements, the CPA proposes journal entries to capitalize improvements recorded as repairs expense and to charge to expense repairs capitalized as improvements; to capitalize production period interest; to allocate indirect overhead costs to the individual contract cost records; to recognize liabilities for subsequent disbursements; to record the valuation allowance for customer account balances; and to record the current and deferred income tax provisions. Those are adjustments of the accounting records prepared by the entity. Accordingly, the authors would not view them as bookkeeping services, and, therefore, would not view them as subject to ET 1.295.

106.37 CPAs who are faced with difficult judgments as to whether they are providing bookkeeping services are not precluded from concluding that they are providing services subject to ET 1.295 and following its requirements. Beginning at paragraph 202.48 of *PPC's Guide to Audits of Nonpublic Companies* is a discussion of more questions and answers in applying ET 1.295.

106.38 The Accountant's Ability to Perform the Requested Service

Accountants may not always be able to provide the requested level of service for a client for a variety of reasons. One common example involves contractors that have not been audited or reviewed in the past. In these cases, the CPA is often unable to obtain enough objective information about the beginning balance sheet accounts to provide any assurance on the current year financial statements. This situation is discussed in more detail beginning in paragraph 510.2.

Overview of Factors to Be Considered in Determining the Level of Service to Be Provided

106.39 There are a few rules of thumb that normally can be used in determining the appropriate level of service to be performed for a construction contractor. They include the following:

- a. Third parties (banks, bonding companies, etc.) will usually accept a lower level of service for interim financial statements than for annual statements. For example, banks that insist on receiving audited annual statements will usually accept reviewed (or even compiled) monthly or quarterly statements.

b. Third parties normally insist that the contractor's annual statements be either reviewed or audited. Compiled statements are therefore used primarily for internal use or interim reporting to third parties.

c. The more a third party stands to lose, the more likely the third party is to insist on receiving audited annual financial statements. For example, a bank may be willing to accept reviewed financial statements from a contractor who has a line of credit of \$100,000, but insist on audited financial statements if the line increases to \$1 million.

d. A contractor is more likely to obtain a surety bond with audited financial statements than with reviewed or compiled financial statements. In many instances surety bonds will not be available without audited statements. (See the discussion beginning at paragraph 203.11 and section 204.)

106.40 As a construction contractor's business grows, so does the need for higher levels of accounting services. In paragraph 106.39 item c., for example, the accountant needs to anticipate increasing the level of service from a review to an audit as the outstanding borrowings approach \$1 million. In item d., the contractor's ability to obtain bonding for larger contracts may be limited without an audit. Therefore, it may be appropriate for the accountant to perform certain significant audit procedures (such as performing site visits and confirming contract receivables) even though the bank is still accepting review reports. This will allow the CPA to increase the scope of service to an audit whenever the bank changes its requirements.

¹ On May 28, 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts With Customers (Topic 606)*, which will be effective for nonpublic entities for annual reporting periods beginning after December 15, 2017, and interim reporting periods after that annual reporting period. However, on April 29, 2015, the FASB released a proposed ASU that would allow a one-year delay. The guidance in the new ASU will supersede existing GAAP for revenue recognition, including the percentage-of-completion and completed-contract methods. See further discussion of this revenue recognition accounting guidance beginning at paragraph 301.12 and discussion of the proposed one-year delay at paragraph 301.18.

² In May 2014, the AICPA issued a revised *Code of Professional Conduct*, which became effective as of December 15, 2014, with the exception of two broad conceptual frameworks, one for members in public practice and one for members in business, that are effective as of December 15, 2015. The

revised Code has been fully incorporated into this *Guide*. See further discussion beginning at paragraph 106.17.

³ In addition to the AICPA's *Code of Professional Conduct* and underlying interpretations, a variety of independence-related resources are available to the CPA. The AICPA offers professional ethics information on its website that provides resources, publications, and recent developments on the topic of professional ethics. The website is located at

www.aicpa.org/InterestAreas/ProfessionalEthics/Pages/ProfessionalEthics.aspx (click on Resources).

⁴ The requirement regarding the cumulative effect on independence is effective for engagements covering periods beginning on or after December 15, 2014.

⁵ These activities are considered nonattest services effective for engagements covering periods beginning on or after December 15, 2014.

⁶ *PPC's 1120 Deskbook* provides an illustration of a separate detailed engagement letter for tax return preparation services.

⁷ These activities are considered nonattest services effective for engagements covering periods beginning on or after December 15, 2014.

⁸ Although the practitioner may comply with the independence requirements of ET 1.295 when performing bookkeeping services or assisting the attest client in drafting the financial statements, the practitioner considers whether a control deficiency exists that needs to be communicated under AU-C 265. AU-C 265 indicates that improperly designed controls over preparation of the financial statements and employees who lack the skill and knowledge to apply GAAP are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses. Section 605 provides guidance on communicating internal control matters.

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107 Construction-Related Associations

107.1 Construction associations offer many potential benefits to internal accountants and practitioners. For internal accountants, associations may provide information such as key industry statistics and comparative financial data for analyzing company performance and identifying areas for improvement. Associations may also provide networking opportunities with other internal accountants and other professionals serving the construction industry. These networking opportunities allow accountants to discuss: (a) common accounting and reporting issues, (b) current trends in the construction industry, and (c) service providers such as sureties, attorneys, accountants, and insurance carriers.

107.2 Associations can also benefit practitioners by providing: (a) a target audience for marketing accounting, audit, and/or tax services, (b) access to key industry statistics for analytical procedures and consulting services, and (c) an opportunity to become involved in the industry.

107.3 Some of the national associations that both industry and public accountants may want to consider joining include:

American Institute of Architects
(800) 242-3837
www.aia.org

Society of Industrial and Office Realtors
(202) 449-8200
www.sior.com

Associated General Contractors of America
(800) 242-1767
www.agc.org

Associated Builders and Contractors, Inc.
(202) 595-1505
www.abc.org

Building Owners and Managers Association Int'l
(202) 408-2662
www.boma.org

Construction Financial Management Association
(609) 452-8000
www.cfma.org

Construction Industry
CPAs/Consultants Association
(480) 836-0300
www.cicpac.com

Design-Build Institute of America
(202) 682-0110
www.dbia.org

American Subcontractors Association,
Inc.
(703) 684-3450
www.asaonline.com

A listing of other national, regional, and local construction-related associations is available at
www.4specs.com/s/assoc.html.

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