Construction Industry Audit Technique Guide (ATG) - Appendixes

Publication Date - May 2009

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Appendixes

Appendix 1 Federal Tax Law and Guidance

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00/00/0000	IRC Section 263	Capital expenditures.
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05/06/2002	Rev. Proc. 2002-28	This procedure provides an exception from using an accrual method of account and accounting for inventories to qualifying taxpayers in certain eligible businesses with average annual gross receipts of $10 million or less.
05/06/2004	Rev. Proc. 2004-34	Provides procedures under which accrual basis taxpayers may defer the inclusion in income of payments received (or amounts due and payable) in on taxable year for services to be performed in a subsequent year. This Revenue Procedure supersedes Revenue Procedure 71-21
09/26/1983	W.C. & A.N. Miller Development Company v. Commissioner, 81 T.C. 619 (1983)	Taxpayer improperly changed to a LIFO method of accounting for its home construction costs. The individual homes, which the taxpayer sold, were real estate and did not constitute "merchandise" within the meaning of Treasury Regulation Section 1.471-1.
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07/17/2000	Tutor-Saliba Corporation v. Commissioner, 115 T.C. 1 (2000)	Disputed claims are part of contract price for percentage of completion method of accounting as soon as it is reasonably estimated that the claims would be received, not when the all-events test is met.
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Appendix 2 Tax Accounting Methods

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Type	Available Accounting Methods for Long-Term Construction Contactors Required to Use Percentage of Completion Method under IRC Section 460
Percentage of Completion Method (PCM)	IRC Section 460(b)(1)(A) and Treasury Regulation Section 1.460-4(b) generally require that the PCM be computed utilizing the “cost-to-cost” method which is: (Total cumulative allocable contract costs incurred to end of taxable year / Total estimated allocable contract costs) x Contract price = Cumulative gross receipts - cumulative gross receipts from immediately preceding taxable year = Current-year gross receipts - Allocable contract costs incurred during current year = taxable income to be reported during the taxable year. Upon contract completion, IRC Section 460(b)(1)(B) requires interest computed under the “look-back” method.
Simplified Cost-to-Cost Method	IRC Section 460(b)(3)(A) and Treasury Regulation Section 1.460-5(c) provide an elective simplified procedure for determining the contract completion factor for taxpayers using PCM. Only three costs are used in determining the percentage of completion: 1. Direct material costs 2. Direct labor costs 3. Depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the long-term contract
Percentage of Completion - 10% Method	IRC Section 460(b)(5) - The taxpayer may elect to defer recognition of revenue under PCM until 10% of the estimated total contract costs are incurred and allocated. This election is unavailable if the taxpayer elected the simplified method mentioned above.
Percentage of Completion - Capitalized Cost Method (PCCM)	A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the PCM or the PCCM. Under the PCCM, this taxpayer must report 70% of the contract under PCM (as required by IRC Section 460) and the remaining 30% under a permissible exempt method (e.g., Completed Contract, exempt PCM, etc). See Treasury Regulation Section 1.460-4 (e). A residential construction long-term contract differs from a home construction contract in that a home construction contract involves buildings with four or fewer dwelling units, whereas a residential construction long-term contract involves buildings with more than four dwelling units. Definitions are found in IRC Section 460 (e).
Cash Method	The general rule requires the taxpayer to report income when received and deduct expenses when paid. This method is available for taxpayers that are not prohibited by IRC Section 448 from using this method and meet the requirements of Revenue Procedure 2001-10 or 2002-28. Revenue Procedure 2001-10 permits eligible small taxpayers (with average annual gross receipts equal to or less than $1 million) to use the cash method when an accrual method would normally be required by IRC Section 471 due to inventory. Revenue Procedure 2002-28 extends the use of the cash method to certain qualifying taxpayers who are not prohibited by IRC Section 448 from using the cash method and who have average annual gross receipts of $10 million or less.
Accrual Method	The general rule is that income is reported when due, earned, or received, whichever comes first. Under an accrual method of accounting, expenses are deductible when all events have occurred that establish the fact of the liability, the amount can be determined with reasonable accuracy, and not earlier than when economic performance has occurred. An accrual method taxpayer may, however, elect the provisions of Revenue Procedure 2004-34, which defer the inclusion in income of payments received in one taxable year for services to be performed in a succeeding taxable year. This election is available only for advance payments received for services.
Accrual with Deferred Retainages Method	Revenue Ruling 69-314 allowed an accrual-basis taxpayer to elect to defer the inclusion in income of retainages withheld by the customer until final acceptance by the customer occurred as specified in the contract.
Completed Contract Method (CCM)	The general rule is that all income and expenses (both direct and indirect) related to a contract are deferred until the job is complete. Because of this deferral, this method is generally the one preferred by taxpayers who are exempt from using the PCM.
Exempt-Contract Percentage-of-Completion Method (EPCM)	A taxpayer who is exempt from the requirement to use the PCM under IRC Section 460 (using the cost-to-cost method) still may elect a similar PCM. The taxpayer must include in income the portion of the total contract price that corresponds to the percentage of the entire contract completed during the taxable year. However, the completion may be determined by using any method of cost comparisons, such as direct labor costs incurred to date to estimated total labor costs, or by comparing work performed with estimated total work to be performed (e.g., units of production). See Treasury Regulation Section 1.460-4(c)(2).

Appendix 3 Construction Industry Resources

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Name	Source	Description
Associated Builders and Contractors (ABC)	http://www.abc.org/	A national trade association representing About 23,000 contractors, subcontractors, and material suppliers. This website also provides license requirements by state.
Associated General Contractors (AGC)	http://www.agc.org/	The largest and oldest construction trade association.
American Institute of Certified Public Accountants (AICPA)	http://www.aicpa.org/	The AICPA is the national professional organization for all Certified Public Accountants. It provides members with the resources, information, and leadership to enable them to provide services in the highest professional manner to benefit the public, employers, and clients.
American Institute of Architects (AIA)	http://www.aia.org/	The AIA is the voice of the architecture profession dedicated to serving its members; advancing their value; and improving the quality of the building environment. The AIA documents are standard forms in the building industry.
American Institute of Constructors (AIC)	http://www.aicnet.org/	AIC is an organization established to help individual construction practitioners achieve the professional status they deserve..
American Subcontractors Association (ASA)	http://www.asaonline.com/	ASA is comprised of professional constructors, suppliers, and service providers representing the construction industry through advocacy, leadership, education and networking.
Blue Book of Building and Construction	http://thebluebook.com/	Provides a listing of over 1,000,000 general contractors, subcontractors, architects, engineers by regional area.
Builder Online	http://www.builderonline.com/	Comprehensive building information with numerous links.
Building Online	http://www.buildingonline.com/	Search over 100,000 building related sites. Links to builders, retailers, news, trade shows, contractor directories, home improvement tips, accounting and estimating software.
Construction Financial Management Association (CFMA)	http://www.cfma.org/	CFMA is a source of education and information on financial management to the construction industry. Over 7,000 members.
Construction Industry CPA Consultants (CICPAC)	http://www.cicpac.com/	CICPAC is a national, not-for-profit association for CPA firms providing financial and consulting services to the construction industry.
Construction Management Association of America (CMAA)	http://cmaanet.org/	CMAA supports construction managers ton enhance their performance and improving their business results. CMAA also provides information about the construction management practice.
Design Build Institute of America (DBIA)	http://www.dbia.org/	To promote the use of design-build project delivery. DBIA sponsors educational programs, publishes a Manual of Practice and Design-Build Contract Documents, public outreach and private facility owners.
Mechanical Contractors of America Association (MCAA)	http://www.mcaa.org/	MCAA is an association of more than 2,200 mechanical, plumbing, and service contractors.
National Association of Homebuilders (NAHB)	http://www.nahb.org/	The NAHB is a federation of more than 800 state and local builder associations throughout the US. The mission of this association is to enhance the climate for housing and the building industry, and to promote policies that will keep housing a national priority.
Plumbing, Heating, Cooling Contractors	http://www.phccweb.org/	PHCC is a nationwide organization with approximately 3,700 members. This association is the advocate for the plumbing, heating, and cooling

Association (PHCC)		contractors.
Secretary of State		Search Secretary of State websites for any state to find information on companies address, related companies and registering agent.
Securities Exchange Commission (SEC)	http://www.sec.gov/	Provides extensive information on publicly traded companies, including the 10-K, 10-Q filings
Taxpayer Website	Google Search	Search construction company's website for annual reports, officers, headquarters, and subsidiaries.
Constructor	Monthly	Magazine published by the Associated General Contractors of America (AGC). The magazine can be downloaded, free of charge at http://www.agc.org/
Builder	Monthly	Magazine published by the NAHB. Website is at http://www.nahb.org/
Building Design & Construction	Monthly	Focuses on design and construction of nonresidential buildings for architects, engineers, and construction managers. Articles can be downloaded free of charge from their website: http://www.bdcmag.com/
CFMA Building Profits	Bi-monthly	Magazine published by the Construction Financial Management Association (CFMA) The website is at http://www.cfma.org/
Journal of Construction Accounting and Taxation	Bi-monthly	Articles on financial and tax accounting published by RIA (Research Institute of America). RIA is a business unit of The Thomson Corporation which was formed with the merger of RIA, Computer Language Research (CLR), and Warren, Gorham, & Lamont G&L. http://riahome.com/
Engineering News Record (ENR)	Weekly	Magazine published by McGraw Hill Construction. Ranking of contractors by type and gross income. plus articles on companies and projects. http://www.enr.com/
Updated annually	PPC (Practitioners Publishing Company) Guide to Construction Contractors	Three-volume guide that discusses the industry in detail. The guide covers both financial and tax aspects.
Updated annually	PPC (Practitioners Publishing Company) Guide to Real Estate	Three-volume guide that discusses the development of real estate in detail. The guide covers both financial and tax aspects.
Updated annually	WG&L (Warren, Gorham & Lamont) Construction Controller' Manual	Provides insight to the complex accounting, tax, insurance, legal, and financial issues of the construction sector.
Updated annually	Robert Morris Associates (RMA) Annual Statement Studies	Provides comparative financial data for all types of businesses organized by SIC/NAICS codes.
Updated annually	CFMA Construction Industry Annual Financial Survey	The survey contains financial data organized by type of construction, dollar volume, and geographic region
Updated annually	CCH Construction Guide Tax and Advisory Services	Provides in-depth tax rules pertaining to the construction contractors in an "easy-to-read" format.
Regularly Updated - not necessarily annual	AICPA Construction Contractors	AICPA Audit and Accounting Guide
Updated Annually	AICPA Audit Risk Alert on the Construction Industry	No authoritative practice aids designed to be used as engagement planning tools. The alerts are resources for checking vital audit considerations that might otherwise be overlooked
June 1953	ARB (Accounting Research Bulletin) No. 43 Government Contracts	Chapter 11 prescribes generally accepted accounting principles in three areas of accounting for government contracts. Section A deals with accounting under cost-plus-fixed-fee contracts. Section B deals with aspects of government contracts and subcontracts that are subject to renegotiation. Section C involves accounting for terminated war and defense contracts
October 1955	ARB No. 45 Long- Term Construction Type Contracts	Describes the two generally accepted methods of accounting for long-term construction-type contracts: percentage-of-completion method and the completed-

		contract method.
July 15, 1981	SOP (Statement of Position) 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts	Provides additional guidance on the application of the generally accepted accounting principles set forth in ARB No. 43 & 45. SOP 81-1 establishes a strong preference for the percentage-of-completion method

Appendix 4

Part A: Cost Allocation Decision Making Process

Step 1: Is there a contract?

A. No. IRC Sections 263(a) and 263A - Land Developers and Speculative Homebuilders apply.
B. Yes. Go to **Step 2**.

Step 2: Is the Taxpayer Exempt from IRC Section 460?

A. If the taxpayer is a Home Contractor the taxpayer is exempt from IRC Section 460. Go to **Step 3**.
B. If the taxpayer's contracts are for less than 2 years and the taxpayer has gross receipts less than $10 million, the taxpayer is a Small Contractor, and the taxpayer is exempt from IRC Section 460. Go to **Step 3**.
C. If the taxpyer is not a Home Contractor, or a Small Contractor, the taxpayer is not exempt from IRC Section 460. IRC Section 460(c) Treasury Regulation Section 1.460.5(b) May Elect Simplified Cost-to-Cost Method IRC Section 460(b)(3)(A) Treasury Regulation Section 1.460.5(c) applies.

Step 3: Is the Taxpayer a Large Homebuilder?

A. If contracts are for more than 2 years and the taxpayer has gross receipts of more than $10 million the taxpayer is a Large Homebuilder. Section 263A - Large Homebuilder applies.
B. If contracts are for not more than 2 years and the taxpayer has gross receipts of not more than $10 million the taxpayer is not a Large Homebuilder. Small Contractors and Small Homebuilders accounting method elections are either Treasury Regulation Section 1.460-5(d) for Completed Contract Method, or Treasury Regulation Section 1.460-5(b) for Percentage of Completion Method.

Part B Production Period Interest is Allocable Under All of the Above Under IRC Sections 460 (c)(3) and 263A(f) Cost Allocation by Type of Cost by Accounting Method

Item	Type of Cost	PCM [1]	SCM [2]	CCM [3]	UCC [4]
1	Direct Materials	Yes	Yes	Yes	Yes
2	Direct Labor	Yes	Yes	Yes	Yes
3	Repairs	Yes	No	Yes	Yes
4	Maintenance	Yes	No	Yes	Yes
5	Utilities	Yes	No	Yes	Yes
6	Rent	Yes	No	Yes	Yes
7	Certain Indirect Labor	Yes	No	Yes	Yes
8	Materials and Supplies	Yes	No	Yes	Yes
9	Small Tools and Equipment	Yes	No	Yes	Yes
10	QC & Inspection	Yes	No	Yes	Yes
11	Taxes (Other than Income Taxes)	Yes	No	Yes	Yes
12	Financial Statement Depreciation	No	No	Yes	No
13	Tax Return Depreciation	Yes	Yes	No	Yes
14	Cost Depletion	Yes	No	Yes	Yes
15	Percentage Depletion in Excess of Cost	Yes	No	No	Yes
16	Contract General And Administrative Expense	Yes	No	Yes	Yes
17	Non-Contract G&A Expense	Yes	No	No	Yes
18	Administrative Support Departments	Yes	No	No	Yes
19	Contract Related Officer Salaries	Yes	No	Yes	Yes
20	Non-Contract Related Officer Salaries	Yes	No	No	Yes
21	Insurance (Including Bonds)	Yes	No	Yes	Yes

22	Pension, Profit Sharing. Except for Past Service Costs	Yes	No	No	Yes
23	Past Service Costs	Yes	No	No	Yes
24	Direct Research and Development	Yes	No	No	Yes
25	Rework, Scrap, and Spoilage	Yes	No	No	Yes
26	Successful Bidding Expense	Yes	No	No	Yes
27	Engineering and Design	Yes	No	No	Yes
28	Transportation Costs	Yes	No	Yes	Yes
29	Storage, Handling, Purchasing and Related Costs	Yes	No	No	Yes
30	Production Period Interest	Yes	No	Yes	Yes
31	Additional Costs under Cost Plus or Governmental Contracts	Yes	No	No	Yes
32	Marketing, Selling, Advertising, and Distribution	No	No	No	No
33	R & D Not Related to Contracts	No	No	No	No
34	Losses, Obsolescence, Decline in Value	No	No	No	No
35	Income Taxes	No	No	No	No
36	Costs Attributable to Strikes	No	No	No	No
37	Repairs Not Associated with Production Equipment	Yes	Yes	Yes	Yes

Notes

[1] Required by IRC Sections 460 and 460(c) and Treasury Regulation Section 1.460-5(b)
[2] Allowed by IRC Sections 460(b)(3)(A) and Treasury Regulation Section 1.460-5(c)
[3] Allowed by Treasury Regulation Section 1.460-5(d)
[4] IRC Sections 263A (Large Homebuilders, Specification Homes, and Land Developers

Appendix 5 Definitions and Terminology

Appendix 5 Definitions and Terminology

Term	Definition
Advance Payments	Payments generally made to a prime contractor prior to the performance of any work under a contract. These payments help the contractor cover developmental and preliminary costs incurred prior to commencement of work.
Advances on Contracts	A current liability on the books of contractors where billings on contracts exceed accumulated costs.
Aggregating	The process of treating two or more agreements as one contract for the purpose of clearly reflecting income.
Assemblage	Acquisition of contiguous properties by one owner for a specific purpose, such as the development of a housing tract.
Award	Notification given to a bidder informing him or her that his or her bid was accepted.
Back Charges	Billings between parties, such as from owners to general contractors or general contractors to subcontractors, covering expenses, which, according to the contract, should have been incurred by the party to whom billed.
Backfill	Soil or other materials used to fill an excavation.
Backlog	The accumulation of unfinished jobs of a contractor, including those not started, measured by the amount of revenue expected to be received from them.
Betterment	Improvement to real property, such as the addition of a sidewalk that increases the property’s value. It’s not a repair, restoration, or enlargement.
Bid	A formal offer from a contractor, which specifies the price to be charged for completing, work in accordance with project specifications and contract requirements.
Bid Bond	A bond issued on behalf of a contractor that provides for the payment of the difference between the contractor’s bid and the next lowest bid if the contractor’s bid is accepted and the contractor fails to enter into a contract or furnish such bonds as required by the contract.
Bid Rigging	Any collusive action by contractors that restricts the competitive bidding process by manipulating the bids submitted on a project or projects (such as, inflating bid proposals or predetermining the lowest bidder).

Bonding Capacity	The total dollar amount of the construction bonds (or maximum value of incomplete work) that a surety company will underwrite for a contractor.
Bonus	A premium paid to the contractor in excess of the basic contract price as a reward for meeting various goals stated in the contract; for example, completing the project prior to the contract completion date. The provisions for bonuses are stipulated in the bonus clause of the contract and are in contrast to the penalty clause.
Bridge Loan	Short-term loan to cover the period between the termination of one loan and the beginning of another loan; for example, the period between the construction loan and the permanent loan.
Broker	A party that acts as the general contractor for a project but subcontracts all of the construction work required under the contract.
Building Permit	Permission granted by the local government to construct a building or to make property improvements.
Build to Suit	Method of leasing whereby the lessor agrees to make tenant improvements to the lessee's specifications in return for the lessee's long-term commitment to lease the space.
Buy-Down	Technique used to facilitate the sale of property. The buyer is offered a below-market interest rate on a mortgage loan for an initial number of years. The developer or other seller pays the lender the difference between the below-market rate and the market rate during the buy-down period, after which the borrower pays the full interest cost.
Certificate of Occupancy	Written authorization issued by a local government stating that the structure is ready and fit for occupancy.
Certificate for Payment	Statements prepared by an architect to inform the owner of the amount due a contractor as a result of work completed on a project.
Change Order	A modification of the provisions of a contract, such as a change in specifications or manner of performance that may be initiated by either the owner or the contractor.
Claims	Amounts in excess of the original contract price that the contractor seeks to collect from the owner or others due to unanticipated circumstances; for example, owner-caused delays, errors in specifications, contract terminations, and disputed change orders.
Class A Office Building	Relatively new office building in a prime location, with a high occupancy rate and highly competitive rental rates.
Class B Office Building	Older office building that has been fully renovated to modern standards that is in a prime location with a high occupancy rate and competitive rental rates or newer building that is not in a prime location.
Closing Statement	A settlement statement. Detailed cash accounting of a real estate transaction prepared by an escrow officer, broker, or attorney.
Cluster Development	Subdivision development in which detached houses are built close together. It results in allowing little individual yard space.
Commercial Real Estate	Income-producing property, such as shopping centers, offices, hotels, or apartments.
Commitment	A promise to perform a certain act such as making a loan.
Commitment Fee	Fee paid for a written promise to make or insure a loan for a predetermined amount and on specified terms.
Completed Contract Method	One of the two generally accepted methods of accounting for long-term contracts under which all contract income and all contract costs are deferred until the year in which the contract is finally completed and accepted.
Completion Bond	A bond, generally given to the owner and the lender, guaranteeing completion of a project and the provision of funds to complete it.
Construction Contract	Any contract for the building, construction or erection of or the installation of any integral component of, or improvements, to real property. A construction contract generally specifies the work to be performed and the terms of payment.
Construction Contractor	A person or entity that enters into an agreement to build, construct, or install improvements to real property according to the owner's specifications.
Construction in Progress	A current asset of contractors where accumulated costs exceed billings on a contract.
Construction Loan	Mortgage loan used to finance real estate construction. It may include funds for acquiring land for the construction project and the permanent financing of the completed project.
Construction Management	The function of managing and coordinating the construction of a project including the negotiating of contracts with others to perform the construction work.
Contract Bond	A bond to indemnify the owner against the failure of a contractor to comply with the requirements of a contract.

Contract Cost Breakdown	A schedule showing the various elements and phases of work in a construction project and the cost of each.
Cost Plus Contract	A contract, which provides for reimbursement to the contractor of the costs incurred in completing the work plus some additional amount to compensate the contractor for profit, overhead, and performance. Different types of cost-plus contracts include cost-plus-fixed-fee, cost-plus award-fee, and cost-plus-incentive fee.
Cost Plus Award Fee Contract	A type of cost-plus contract in which the fee consists of a fixed-fee plus an amount which varies according to the level of performance of the contractor in areas such as cost savings and timeliness.
Cost Plus Fixed Fee Contract	A type of cost-plus contract in which the fee is usually a stipulated sum or a percentage of cost.
Cost Plus Incentive Fee Contract	A type of cost-plus contract in which the fee is based on either cost savings or performance. It varies according to the level the contractor achieves in meeting such cost or performance criteria.
Critical Path Method	A method of scheduling construction activities according to sequence and interdependence. The sequence of activities that allows the project to be completed in the shortest time is called the critical path.
Delayed Billings	Billings from a contractor for which he or she was entitled to payment in previous billing periods.
Design Construction Contract	A single contract in which the contractor agrees to provide the design, procurement, and construction services necessary to complete a project.
Design Management Contract	A contract in which construction is performed by a number of independent contractors in a manner similar to the professional construction management concept.
Developer	A person or entity that prepares raw land for development. The developer may develop the land and then sell it to a builder, an investor, or another developer.
Development Agreement	Agreement under California law by which local governments and developers can defend their respective interests during the development period. Such agreements can protect developers against changes in public policies that can cause delay or abandonment of a development project even though the developer has spent substantial funds for development.
Development Loan	A loan for off-site improvements such as streets and utilities as opposed to a construction loan.
Direct Cost	Any labor, material, job overhead, or other cost that is directly attributable to a specific construction job.
Draw	The amount of progress payments that is currently available to a contractor under a contract with a fixed payment schedule.
Engineering Contract	A contract for engineering services only, as opposed to the actual construction of a project.
Escalation Clause	A provision in contracts providing for upward adjustments to be made in the contract price of certain items or elements of work when conditions affecting the cost change.
Estimates	These are estimated costs of a construction project. A project has three types of estimates during the evolution of the project. Conceptual estimates are generally made in the early phases of a project for the owner to consider whether the project is economically feasible. Detailed estimates are made after the design has been approved. These require a careful tabulation of all the quantities for a project or portion of a project (quantity takeoff or quantity survey). A definitive estimate is made after the initial approximate estimates become more defined and accurate as additional information is developed. Definitive estimates forecast the final project cost with little margin for error.
Factory Built Houses	Houses whose shells are factory-built and assembled at the building site to reduce construction costs.
Fast Tracking	A system of scheduling the design and construction in such a manner that both phases progress simultaneously, with an appreciable reduction in the total time to complete the project.
Final Acceptance	The owner's acceptance of the project from the contractor upon certification by an architect or engineer that it has been completed according to contract requirements. Final acceptance usually precedes the date when the owner makes the final payment. The procedures to determine final acceptance will be specified in the contract.
Final Inspection	The final review or inspection of a project performed by an architect, engineer, or construction manager in order to certify that work has been completed according to the contract requirements, after which the final certificate for payment may be issued.
Financial Engineering	The providing of assistance by the contractor to the client in arranging for the long-term financing of the project. This is an emerging feature in some large contracts, which requires the contractor to submit a financial package with his or her bid.
Fixed Price	Agreement in which the contractor agrees to perform the required work in return for a fixed price

Contract	stipulated in the contract.
Front End Loading	A common strategy used by contractors under which higher relative values are assigned to work to be completed in the early stages of a contract than to the work to be completed in the later stages. The result is that progress billings during the early stages exceed the actual value of the work done causing the contractor's revenue from the project to be higher during the early stages. See Unbalanced Bid.
General Contractor	A contractor who contracts with an owner to be responsible for all of the construction work necessary to complete a project, even though subcontractors may be used to perform part of the work.
Guaranty Bond	A type of bond guaranteeing that the contractor will complete the work according to the contract and pay all obligations. It is also known as a surety bond. If the bond guarantees completion of the work it is a performance bond or completion bond. If it guarantees payment of obligations it is a payment bond.
Hard Dollar Costs	Cash outlays for land, labor, and improvements.
Historic Structure	Pre-1936 building that qualifies for special rehabilitation tax credits as a historic structure under the Tax Reform Act of 1986. See IRC section 47 (c)(1)(B).
Holdback	A contract item that can be delayed in finalization. See "Retainage".
Improvement Bond	Bond issued by public agency to finance the construction of improvements such as highways and streets.
Indirect Costs	Generally, overhead expenses of the contractor that is not directly attributable to a particular construction project.
Invited Bid	A bid submitted by one of a selected group of contractors who have received an invitation to bid on a project, as opposed to bidding that is open to all qualified contractors.
Job Costs	Costs that can be allocated to specific jobs of a contractor such as material, labor and job overhead costs. See Overhead Costs.
Job Overhead Costs	Costs that can be allocated to specific jobs of a contractor such as material, labor, and job overhead costs. See Overhead Costs.
Joint Venture	A cooperative undertaking, by two or more parties (contractors), operated as a separate business entity for the purpose of combining resources and sharing risks on a construction project.
Kickbacks	Payments made without any legal obligation, usually to individuals in return for their influence in obtaining a contract.
Labor and Material Payment Bond	A type of guaranty bond, which guarantees the owner that all costs of labor, material, and supplies incurred by the contractor in connection with a project, will be paid.
Labor and Material Release	Document signed by laborers and material men waiving their rights under any mechanic's lien against the developer.
Letter of Credit	A document issued by a financial institution guaranteeing the payment of its client's debts up to a stated amount for a specific period.
Lien	Legal claim against specific property of the owner to secure payment of amounts due to material suppliers or contractors, who are engaged in the construction of a project.
Liquidated Damages	Amounts stipulated in the contract, usually as a fixed amount per day, that the contractor is obligated to pay the owner as compensation for damages suffered as a result of the contractor's failure to complete the work within a specified time.
Loan Commitment	See Commitment.
Loan Origination Fees	Lender's charge for services in originating a mortgage. Such fees typically are 1 to 2 percent of the amount of the loan.
Long Term Contract	A building, installation, construction, or manufacturing contract, which is not completed within the taxable year in which it is entered.
Lot Block	Records maintained by a title company of recorded transactions affecting a particular property.
Lump Sum Contract	See Fixed-Price Contract.
Maintenance Bond	A bond guaranteeing the owner that, for a specified time following the completion of a project (warranty period), any defects in workmanship or materials will be rectified. A one-year maintenance bond is normally included in the performance bond.
Mechanic's Lien	A lien on real property in favor of persons supplying labor or materials for a building or structure, generally for the value of the labor or materials provided. A mechanic's lien also exists for

	professional services in some states. Clear title to the property cannot be obtained until the claim is settled.
Negotiated Bid	A bid proposal from a specific contractor (selected on the basis of reputation, past performance, quality of work, expertise, or other reasons) in which the terms and conditions are negotiated between the owner and contractor, as opposed to the competitive bidding process under which the lowest bid is sought from various qualified contractors.
Offsite Costs	Expenditures incurred for the improvement of raw land that are not related to the construction of the building such as, curbs, gutters, sidewalks, and streets.
Off Balance Sheet Financing	Financing that does not appear on the balance sheet such as, operating leases.
Onsite Costs	Expenditures incurred for the actual construction of a building.
Overhead Costs	May refer to either job overhead or operating overhead costs. Job overhead costs are direct costs of work, which can be allocated to a specific job, but they cannot be allocated to specific items of work within that job. Operating overhead costs are indirect costs of operating a construction business that cannot be allocated to specific jobs.
Owner	The customer of a contractor, architect, or engineer who generally owns the right to the land on which the project is being built.
Payment Bond	A bond guaranteeing payment of the contractor's obligations incurred in connection with a project. See Labor and Material Payment Bond.
Penalty Clause	In contrast to the bonus clause, this provision of the contract provides for a reduction of the amount payable under a contract if the contractor fails to meet specified targets or project specifications.
Percentage of Completion Method	One of the two generally accepted methods of accounting for long-term contracts in which the amount of gross income reportable in each year is that portion of the gross contract price which represents the percentage of the entire contract completed during the year.
Performance Bond	A guaranty bond executed by the contractor to protect the owner against the contractor's failure to perform according to the terms of the contract. It is usually combined with a labor and material payment bond.
Phased Construction	See Fast-Tracking.
Pre Qualification	The approval given a contractor under circumstances where an agency or owner requires bidders to meet certain standards. This approval then authorizes the contractor to submit a bid on the project.
Prime Contractor	The general contractor or any major contractor who has a contract directly with the owner.
Profit Center	The unit, usually a single contract, used by a contractor to measure profit or loss for accounting purposes.
Progress Billings	Amounts billed by a contractor during the progress of work on a project. The amounts of the billings are determined in accordance with the terms of the contract, the amount of work completed, and the materials suitably stored. Change orders will affect the progress billings.
Progress Payments	Payments made in response to progress billings.
Progress Schedule	Usually a diagram or other pictorial prepared by the contractor and updated monthly, showing the proposed and actual starting and completion times of the various elements or phases of work included in a project.
Project Manager	An employee of the general contractor or contract manager who is responsible for all work performed on a project.
Punch List	A list prepared by the architect or owner near the completion of a project indicating items to be completed or corrected by the contractor.
Quantity Take Off	A detailed compilation of the quantity of each elementary work item that is called for on the project. These are used in making project cost estimates.
Retainage	Specified amount usually withheld from progress billings pending satisfactory completion and final acceptance of the project.
Severing	The process of treating one agreement as two or more contracts for the purpose of clearly reflecting income.
Specifications	A technical description along with working drawings of the materials, workmanship, special construction methods, and standards required under a contract.
Subcontract	A contract between a prime contractor and a separate contractor or supplier to perform a portion of the work or supply materials for which the prime contractor is responsible to the owner. A contractor who contracts with the general contractor or another prime contractor to perform a specific part of the work required on a project.

Subcontractor Bond	Performance and payment bonds executed by a subcontractor and given to the prime contractor to guarantee the subcontractor's performance and payment of obligations required under the subcontract.
Substantial Completion	The point reached in a project at which all major work has been completed. The remaining costs and potential risks of the contractor are insignificant.
Surety	A person or organization, such as a bonding company who promises in writing to make good the debt or default of another in return for consideration.
Surety Bond	A legal instrument under which a surety (bonding company) agrees to answer to another party (the owner) for the debt, default, or failure of performance of a third party (the contractor).
Time and Materials Contract	A contract that generally provides for payments to the contractor based on the number of direct labor hours expended at fixed hourly rates plus the cost of materials. To cover indirect costs and profit, time (and sometimes material) is charged at marked-up rates.
Turnkey Job	A project on which the contractor is responsible to deliver a completed and operational facility.
Unbalanced Bid	A bid under which the contract price is disproportionately allocated to elements or phases of work on a basis other than that of cost plus overhead and profit. For example, front-end loading is the assigning of higher relative values to the work completed during the early phases of a project, or the assigning of higher profits to high quantity items under a unit-price contract.
Unit of Delivery Method	Under this method, revenue and cost of sales are recorded as units of work are delivered. This is most suitable to production-type contracts where many units of a product are produced in a continuous process (for example, aircraft).
Unit Price Contract	A type of construction contract, which divides the work (or project) into various elements and fixes a price per unit for each element. Thus, payments to the contractor are based on the number of units of work performed for each element. This type of contract is particularly suited to projects where the quantities of work may vary substantially.

Appendix 6 Construction Industry Interview Questions

These questions are intended to be a starting point for generic questions that would be applicable to the examination of a construction company. As with any examination, the questions should be tailored to the specific taxpayer under examination.

General:

1. How many years have you been in the construction industry?
2. What type of construction do you perform?
   - Single Family Homes
   - Multi-family (condominiums)
   - Commercial Buildings
   - Highway
   - Other
3. Where do you perform construction jobs? (Geographically)
   - Local Area
   - Statewide
   - Nationwide
   - International
4. What type of Customers do you enter contracts with?
   - Private
   - City
   - State
   - Federal
5. How do you get customers?
   - Bid -Who makes the bids?
   - Negotiated?
   - What percent of jobs are bid vs. negotiated?
6. What type of contracts do you enter into?
   - Fixed/lump sum contracts
   - Cost +Plus Fee
   - Time and material
   - Other
7. What is average length of a job? (<1 yr., 1-2 yr., more than 2 years)
8. What licenses do you hold? (i.e. general contractor, architect, etc.)
9. Do you have bonding? If yes, who provides the bonding?
10. Are you required to issue certified financial statements? Reviewed Financial Statements? How often?
11. What method of accounting do you use for tax? (Taxpayer can have several different methods if different types of contracts)
    - Percentage of Completion (PCM) - How is degree of completion determined?
    - Cost-to-Cost, Engineer Estimates, Units in Place, Other?
    - Completed Contract - When is a job determined to be complete?
    - Accrual - How and when are customers billed during job?
    - Cash - (can only be used in limited situations)
12. What method of accounting do you use for book/financial statements?
13. How do you determine the price to charge for a job?
    - What costs (direct, overhead, etc.) are included in that figure?

  - Do you have a worksheet or form that you use to arrive at that figure?
  - What type of budget reports are kept and how often are they prepared?

14. What overhead method is used to determine allocation of indirect costs to contracts? (i.e. specific identification (tracing), standard costs, burden ratios such as ratios based on direct labor hours or dollars, machine hours, etc.)
15. (Note: Use the following questions to determine if and how much officer's salary should be charged to jobs)
    - How are officer's salaries determined? (Salary/hourly/year-end bonuses) Get detail description of each officer's job (i.e. who negotiates contracts, who bids, go to job site, work on job site, etc.)
    - Are officer's provided corporate vehicles? Get detailed business use (i.e. going to job sites regularly)

Other Income:

16. Provide Construction management services?
    - Architect, engineering services?
    - Remodeling?
    - Subsequent Work?
    - Warranty Work?
    - Rental Income?
17. Any legal proceedings against you or you against others?
18. Do you make provisions for losses?
19. Do you accrue for estimated warranty expenses?
20. Any estimated losses or expenses accounted for?

Management Accounting:

21. How do you number jobs?
22. Do change orders keep the same job # or assigned a new job #?
23. Do you maintain a budgeting system? (monthly, qrtly, yearly)
24. Describe your job cost system.
    - Explain all costs charged to jobs.
    - Are officer's salaries applied to jobs.
    - Interest expense on construction loans applied to jobs.
    - Indirect costs applied to jobs.
25. Do you obtain financing for jobs or does the customer?
26. Retainages:
    - How much is withheld by customers and when do you received them?
    - When are they included in income for tax? book?
    - How much do you withhold on your subcontractors?
    - When do you repay them? How do you account for them?

Employees and Subcontractors:

27. How many employees do you have and what type of positions within the company?
    - Officers?
    - Office staff?
    - Supervisors?
    - Field workers?
    - Others?
28. What type of subcontractors do you use?
29. How are subcontractors/vendors selected?
30. Do you enter into contracts with subcontractors?
31. How are subcontractor fees determined? (negotiated, hourly, etc.)
32. Who is responsible for the issuance of 1099s to subcontractors?
33. How do you distinguish between employees and subcontractors?

Gross Receipts:

34. How is income received?
    - % up-front?
    - Draws? How often and how determined?
    - At end of contract?
    - Retainages?

Cost of Goods Sold:

35. What materials are purchased for each job?
36. Who orders materials? Who approves the order?
37. Materials shipped to you or directly to job site?
38. Do subcontractors provide their own material or do you purchase for them?
39. Do you have a warehouse/shed to keep materials?
40. What is done with extra materials from a job?
41. Inventory?

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