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Considerations When Balancing Strong Financial Statements and Tax Savings

By Taryn Smith and Robert Mercado | Sunday, December 15, 2019

A contractor's year-end is when the company's financial statements need to be the healthiest. This assures that the requirements set forth by the contractor's surety, financial institutions and, in certain cases, customer prequalifications are met. Often, the primary focus for year-end is the tax liability based on the company's annual earnings. However, sometimes the requirements for financial reporting purposes conflict with expectations regarding taxable income. Planning for this is essential.

CASH BASIS

In 2018, the new Tax Cut and Jobs Act (TCJA) took effect. The TCJA permits companies with less than $25 million of average gross receipts for the prior three years to file an automatic change of accounting method to use the cash basis of accounting for tax reporting purposes. The Gross Receipts Test of $25 million, which was increased from $10 million, is also indexed for inflation.

The cash method can be advantageous for contractors, as it allows for large deferrals of tax-related items. However, from a financial reporting perspective, this method has consequences. For example, a contractor can pay down its accounts payable by depleting cash accounts and drawing down lines of credit. Under the cash method, this would decrease the add-back necessary when completing a cash conversion from an accrual financial statement. While the benefit is a reduction in taxable income, the downfall is the impact on surety credit. Sureties want to see contractors with a promising cash balance and credit line availability on their year-end financial statements.

Under the cash basis method, contractors do not report as revenue any amounts not paid, or constructively received, by a customer as of the year-end. Contractors can work with customers to defer payments on accounts receivable to decrease revenue for tax reporting purposes. It is important to note that a check received by a contractor before year-end is considered to be constructively received. This is a favorable practice regarding a contractor's taxable income.

However, aging accounts receivables more than 90 days old do not work in the contractor's favor. Sureties will most likely remove any accounts receivables more than 90 days old from working capital. Should this happen, it's imperative that a contractor provide any amounts subsequently paid on its accounts receivable that were outstanding as of the date of the financial statements. This will assure full surety credit related to those old receivables.

For tax purposes, contractors can elect to deduct certain prepaid expenses that are reported as current assets on financial statements. Although an excellent tax deferral opportunity, prepaid expenses are removed from working capital when calculating surety credit. Contractors should project what prepaid expenses will be at year-end to see if they can be minimized to reduce the impact on surety credit.

Contractors perform work on change orders that have been approved for scope but not price, which is known as an "unapproved change order." Unapproved change orders are added to the contract value for the amount management believes they will successfully collect. This consequently increases the revenue recorded for those unapproved change orders. Depending on the tax method of accounting used by the contractor, unapproved change orders included in contract values will be recorded as taxable income. Contractors may choose to not record unapproved change orders as part of the contract value until they are approved to reduce taxable income. This practice can have a negative impact on financial reporting.

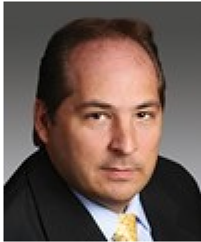
EQUIPMENT

Most contractors rely heavily on equipment to deliver jobs. Equipment for purposes of financial statement reporting is recorded as a fixed asset and depreciated over its estimated useful life. For federal tax reporting purposes, equipment placed into service prior to the contractor's year-end may qualify for IRS Code Section 179 and bonus depreciation accounting methods. Many contractors use these methods to write-off equipment immediately on the tax return. This results in a significant difference in depreciation expense between financial and tax reporting. In addition, accelerating expenses can cause unintended tax consequences at the state level, based on many states not following the same accelerated depreciation rules set forth for federal tax reporting purposes.

Contractors should become educated about how equipment purchases impact their bank covenants along with working capital. Financial institutions usually will have a debt service coverage ratio as part of the covenants required for a contractor's line of credit. Cash paid for equipment will have a negative impact on the bank covenant calculation. Equipment is a long-term asset, as compared to the current asset and liability impact of the cash used and the current maturities of any debt incurred for the purchase. Contractors should first decide whether to purchase equipment based on their need to

reduce taxes; equipment should only be purchased if it is necessary to support the volume of work the contractor has on the books.

Contractors should balance the needs of their sureties, financial institutions and customers with the implications for their tax liabilities. To strike the most advantageous balance, it is best practice to plan for year-end to position the company in the best financial situation possible.



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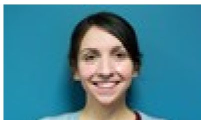

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