## What is Construction Accounting?

Construction accounting is a specialized branch of accounting that caters specifically to the unique financial and operational needs of the construction industry. It addresses the distinct challenges presented by construction projects, such as long-term timelines, complex costing structures, and contractual obligations. Unlike traditional accounting which focuses on routine business transactions, construction accounting revolves around individual projects, ensuring that each is financially viable and monitored closely from initiation to completion.

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| * **Key Takeaways** * \* Construction accounting is a specialized domain, distinct from general business accounting, focusing on the unique dynamics of construction projects. * \* Techniques like the Percentage-of-Completion Method and Completed Contract Method determine when revenues and expenses are recognized in construction accounting. * \* Specialized financial statements, such as the Work-in-Progress Schedule and Construction-in-Progress Report, are essential for tracking ongoing project finances. * \* Implementing and utilizing modern accounting software, along with consistent professional training, are paramount for maintaining accuracy and efficiency in construction accounting |

**How to Account for Construction**

As in other industries, construction [accountants perform critical activities](https://www.netsuite.com/portal/resource/articles/accounting/accounting.shtml) to manage the company’s finances, such as recording transactions, managing cash flow and analyzing profitability. Much of the work of construction accountants is involved with tracking the individual projects that make up most contractors’ workloads. The practice of job costing helps businesses estimate and analyze costs and revenue for each project, keeping projects on track and profitable.

**What does a construction accountant do?**

Construction accountants manage, analyze and update a construction firm’s financial information. Because these firms are generally project-based, much of the accounting team’s work focuses on job costing tasks required to estimate, track and analyze project expenses.

Construction accountants also help companies comply with revenue recognition methods used in the industry. Because of the construction industry’s unique accounting requirements, construction accounting is a specialized skill.

**How do you record construction expenses?**

Construction expenses are generally divided into three major categories: labor, materials and overhead. Within those categories, companies typically have cost codes for needed items, such as types of materials, and generally allocate each expense to a specific construction project. To allocate overhead expenses, most firms first calculate their total overhead, then add overhead expense as a percentage of the project’s labor and materials costs.

**What is the best accounting software for construction?**

NetSuite financial management software automates everyday accounting and handles the unique requirements of the construction industry. It provides real-time access to information from across the company, whether users are in the office or out on project sites. It handles fixed-price, time and materials, cost plus and unit pricing contracts and automates revenue recognition to help companies comply with ASC 606 and specific tax requirements.

**How do you do bookkeeping for a construction company?**

Bookkeeping for construction companies is largely project-based. Bookkeepers need to enter all expenses for each project, typically ensuring each entry is correctly coded so that it is accurately categorized and allocated to the right project. Other work includes recording invoice and payment information.

## Construction Accounting Concepts

Construction accounting includes unique concepts that reflect the specialized practices and requirements of the building industry. These concepts span the entire project lifecycle, from estimating to billing and revenue recognition. The billing method agreed on with clients may vary based on the type of project and the risks involved.

Construction firms may even choose a specific revenue recognition method on a per-project basis depending on factors such as size and expected length. Complex regulatory requirements may also apply to each project.

### Job costing

Because each project typically operates as its own temporary profit center, accurately estimating and tracking all project costs is a critical aspect of construction accounting. Job costing is the process of determining the total cost of completing each job to the contracted specifications. Contractors use this information for estimating, billing and assessing whether in-progress projects are on track. Generally, costs fall into three major categories: labor, materials and overhead. To provide a comprehensive picture of project finances, job costing should account for every stage of the project, including the cost of producing estimates and change orders.

### Contract revenue recognition

For contractors, revenue recognition is a complex topic, largely because of the long-term nature of many projects. The choice of revenue recognition method depends on factors such as the size of the contractor’s business as well as the duration and type of projects the company works on.

**Cash basis method:** In general, companies can use one of two overall accounting methods: [cash basis or accrual basis](https://www.netsuite.com/portal/resource/articles/financial-management/cash-basis-accrual-basis.shtml).

Cash basis is the simplest approach to recognizing contract revenue. With [cash basis accounting](https://www.netsuite.com/portal/resource/articles/financial-management/cash-basis-accounting.shtml), you record revenue when you receive payment and record expenses when you actually pay them. With [accrual basis accounting](https://www.netsuite.com/portal/resource/business-solutions-articles/accrual-accounting.shtml), you record revenue when it is earned and expenses when they are incurred, regardless of when money actually changes hands.

However, construction companies can generally use the cash basis method only if they have average gross receipts of $25 million or less (the threshold was raised from $5 million in the Tax Cuts and Jobs Act, which came into force in 2018). Public companies and many larger businesses must use accrual basis accounting to comply with U.S. Generally Accepted Accounting Principles (GAAP).

Although the simplicity of cash basis accounting is appealing, it can paint a misleading picture of a company’s finances. If a company hasn’t completed a major project by the end of an accounting period, for example, its [financial statements](https://www.netsuite.com/portal/resource/articles/financial-management/income-statement.shtml) will reflect all the project expenses it’s incurred but none of the revenue it’s earned.

**Percentage of completion method:** The percentage of completion method (PCM) enables contractors to recognize revenue as they earn it over the life of a contract. Most contractors recognize revenue using this method, especially if they work on multiyear contracts. In general, contractors with gross revenue over $25 million must use this method for projects that take two years or more, unless a project qualifies as a home construction project as defined under [U.S. Code 460](https://www.law.cornell.edu/uscode/text/26/460).

During a project, contractors recognize revenue for the portion of the work they’ve completed to date. There are several ways to calculate this: The cost-to-cost approach bases the amount on the percentage of estimated job costs incurred to date, while the estimated percent complete approach uses an assessment of the percentage of work completed. A big advantage of the percentage of completion method is that, because it reports income and expenses together throughout each project, it paints a more accurate picture of the company’s finances and smooths out potential swings in revenue and expenses.

**Completed contract method:** With the completed contract method (CCM), contractors recognize all revenue, expenses and profits only when the project is completed. An advantage of this method is that contractors can defer revenue to a future period, thus minimizing tax liability in the current period. Generally, firms may use this method only in limited circumstances, notably for home construction projects. A disadvantage is that CCM is not GAAP-compliant.

In addition, contractors must pay attention to [ASC 606 new revenue recognition standards](https://www.netsuite.com/blog/overcoming-asc-606-revenue-recognition-hurdles).

A recently introduced GAAP revenue recognition standard, [Accounting Standards Code (ASC) 606](https://www.netsuite.com/blog/overcoming-asc-606-revenue-recognition-hurdles) affects how contractors should recognize revenue for long-term contracts using PCM. ASC guidance is that companies should recognize revenue based on performance obligations, which are promises to deliver distinct goods or services to a customer. A contract may include a single performance obligation, or it may include several. Contractors must identify performance obligations in the contract and allocate a price to each.

A second key consideration is transfer of control — the point at which ownership and control of the end product passes to the customer. In situations where the ownership and control of a contractor’s work product becomes the customer’s over time, PCM would be applied to each performance obligation rather than the total contract price.

## Financial Statements Specific to Construction Accounting

Due to the distinct and unique nature of the industry, certain financial statements only exist for construction accounting. These tailored statements address the complexities inherent in construction operations and provide stakeholders with accurate, relevant, and actionable financial data.

### Work-in-Progress (WIP) Schedule

The Work-in-Progress (WIP) Schedule is an integral financial tool in the construction industry. It offers a detailed snapshot of the current financial status of ongoing projects, providing crucial insights into costs incurred and revenues earned. This report includes projected total cost, costs incurred to date, billed revenue, and recognized revenue. Accurate interpretation of WIP data aids in identifying potential project overruns or underruns, assessing project progress against the budget, and guiding financial decision-making for ongoing projects.

### Construction-in-Progress (CIP) Report

The Construction-in-Progress (CIP) Report is designed to track financial data for projects that have commenced but are yet to be completed. It's instrumental in providing an ongoing record of costs and revenues. The CIP report includes a detailed account of ongoing costs, including labor, materials, and overhead. It also shows data on cumulative revenues based on the percentage-of-completion or other recognition methods. With the CIP report in hand, construction firms can evaluate the financial health of individual projects, detect potential financial risks or challenges early on, and ensure consistency in profit margins across projects.

### Job Cost Sheets

Job Cost Sheets serve as the financial blueprint for each construction job. They provide granular insights into the expenses associated with specific tasks or phases. This report includes a comprehensive breakdown of individual job costs, from materials to subcontractor fees and a continuous comparison of actual costs against budgeted amounts. By regularly updating and reviewing job cost sheets, companies can monitor budget adherence in real-time, make timely adjustments to resource allocation, and predict final project costs with greater accuracy.

### Other Relevant Statements

* **Profit and Loss (P&L) Statement:** This statement provides a consolidated view of a project’s revenues and expenses, giving stakeholders insights into the project's profitability.
* **Balance Sheet:** The construction industry balance sheet reflects assets and liabilities unique to the sector, including retentions, advances, construction equipment, and project-specific financing. Properly maintained, it offers a holistic view of a company's financial position.

In the dynamic and multifaceted realm of construction, these specialized financial statements play a pivotal role. They not only ensure precise financial tracking but also underpin the strategic decision-making essential for the sustained success of construction entities.

## 4 Construction Accounting Best Practices

Applying best practices for construction accounting can deliver benefits across the entire business. Accurate job costing, for example, can help businesses see where they’re making or losing money and react quickly before profitability is negatively impacted.

1. **Focus on accurate job costing.** Since contractors are project-based businesses, accurately determining the cost of every project is key to managing profitability. Detailed job costing helps businesses estimate projects accurately, and then track actual versus estimated costs.

[Costing isn’t easy, though](https://www.netsuite.com/portal/resource/articles/accounting-software/essential-guide-to-managerial-accounting.shtml). To accurately estimate a job, every aspect of its labor, materials and overhead costs must be understood. Tracking labor costs is tough when you have a mobile workforce deployed on many different projects. It can be easier when job costing is made a priority for all employees, so they understand its value to the company. Good accounting software and clear, intuitive coding for each job and each cost category can make it easier.

1. **Use cash basis accounting.** For many smaller businesses, cash basis accounting is an appealing choice. Its simplicity typically means lower bookkeeping costs than when using [accrual basis accounting](https://www.netsuite.com/portal/resource/articles/accounting/accrual-basis-accounting.shtml), and it usually provides a clear picture of a company’s actual cash position — which is particularly helpful for smaller businesses with limited funds. Because you only record revenue when you receive payment, you don’t have to pay taxes on sales for which you haven’t yet collected the money. And because you record expenses when you pay them, you may be able to reduce your current year’s tax bill by purchasing additional materials at the end of the year.
2. **Determine the best tax strategy.** Many factors can affect contractors’ income tax liability, including their choice of revenue recognition method, the type of projects they work on and their business structure. The best tax strategy will depend on the business and its needs. Most contractors use the percentage of completion method for recognizing revenue on large contracts. This has the advantage of smoothing out swings in revenue because it records both revenue and associated expenses over the life of a project.

Contractors working on home construction projects may be able to use the alternative completed contract method, which recognizes revenue and expenses only at the end of a project. This can be advantageous for firms looking to reduce tax liability in the current year because it defers revenue and associated income tax to a later period.

Owners or partners in construction firms should think carefully about [the tax implications of their business structures](https://www.netsuite.com/portal/resource/articles/business-strategy/business-structure.shtml). For example, those structured as pass-through entities, such as sole proprietorships or many LLCs, can reduce their personal income tax liability by deducting business losses.

1. **Invest in construction accounting software.** [Modern accounting software](https://www.netsuite.com/portal/products/erp/financial-management/finance-accounting.shtml) can simplify financial management while helping contractors comply with tax laws. Good construction accounting software should automate much of the otherwise laborious work of job costing. Reporting capabilities enable you to track projects and analyze overall business finances in real time, so you can quickly identify problems and take steps to correct them before it’s too late. By managing [accounts receivable](https://www.netsuite.com/portal/resource/articles/accounting/accounts-receivable.shtml) and [accounts payable](https://www.netsuite.com/portal/resource/articles/accounting/accounts-payable.shtml), software can help contractors ensure they collect what they’re owed and stay on good terms with suppliers. Construction accounting software should also help to ensure accurate tax filings, with enough flexibility to support the range of revenue recognition methods used by the construction industry.