

IAS -11

CONSTRUCTION
CONTRACTS

Prepared by:

CA NALIN SHARMA
M- 9910792325

Construction contracts:

Learning outcomes

- ▶ Define a construction contract and describe why recognising profit before completion is generally considered to be desirable; discuss if this may be profit smoothing (IAS 11)
- ▶ Describe the ways in which contract revenue and contract cost may be recognised
- ▶ Calculate and disclose the amounts to be shown in the financial statements for construction contracts

Definitions

Construction Contract – A Construction contract is specifically negotiated for the construction of :

- An asset.
- A combination of asset that are closely interrelated or interdependent

In terms of their design, technology and function or their ultimate purpose or use.

Fixed Price Contract

A Construction contract in which the contractor agrees to a fixed contract price or a fixed rate per unit of output which in some cases is subject to cost escalation clauses.

Cost Plus Contract

Is a construction contract in which contractor is reimbursed for allowable or otherwise defined cost ,
Plus a percentage of these costs or a fixed fee.

Definitions

Construction Contract include contract for :

- The rendering of services which are directly related to the construction of the asset.
- The destruction or restoration of assets and the restoration of the environment following the demolition of assets.

KEY ISSUES

- ▶ Contracts last for several years.
- ▶ Expenses are incurred in one year and Revenue realised in later years.

Concept of accruals and prudence requires:.

- ▶ Revenue and cost should be recognised as they are earned and accrued.
- ▶ Profits should be only recognised when cash realisation is reasonably certain , but provision should be made for costs and losses when foreseen.

IAS 11 requires that costs and revenues associated with a contract should be recognised in profit or loss as the contract activity progresses.

Contract revenue

1) Revenue as agreed in the contract

2) Variations, claims and incentives:

➤ Variations – instruction from customers for changes in the scope of work.

➤ Claims – which the contractor seeks to recover from the customer towards costs not included in the contract price.

➤ Incentives – additional payments by the customer to a contractor who has met or exceeded performance standards.

Contract revenue is measured at the fair value of the consideration received or receivable.

Contract Costs

Cost that directly relate to specific contracts include

- Site labour and supervision costs
- Costs of material used in construction.
- Depreciation of plant and equipment used on the contract.
- Costs of moving plant, equipment and materials to and from
 - the contract site.
- Costs of hiring of plant and equipment.
- Costs of design and technical assistance directly related to contract.
- Cost of rectification and guarantee work.
- Claims from third parties.

Costs specifically chargeable to the contract under the terms of contract.

Contract Costs

Costs generally related to contract activity that can be allocated to the contract, such as

- Construction overheads eg salaries of engineers supervising a number of sites
- Insurance of a number of sites
- Costs of design and technical fees related to a number of sites

Recognition and Measurement

- Contract should be **considered on a contract by contract** basis.
- **Two or more** contracts can be combined to be considered **as one** if **negotiated as package**, closely interrelated and performed concurrently.
- A **contract may be segmented** in to two or more separate contracts.

RECOGNITION & MEASUREMENT – CONTRACT REVIEW

**The rules in IAS 11 provides for three possibilities
Arising on contract review**

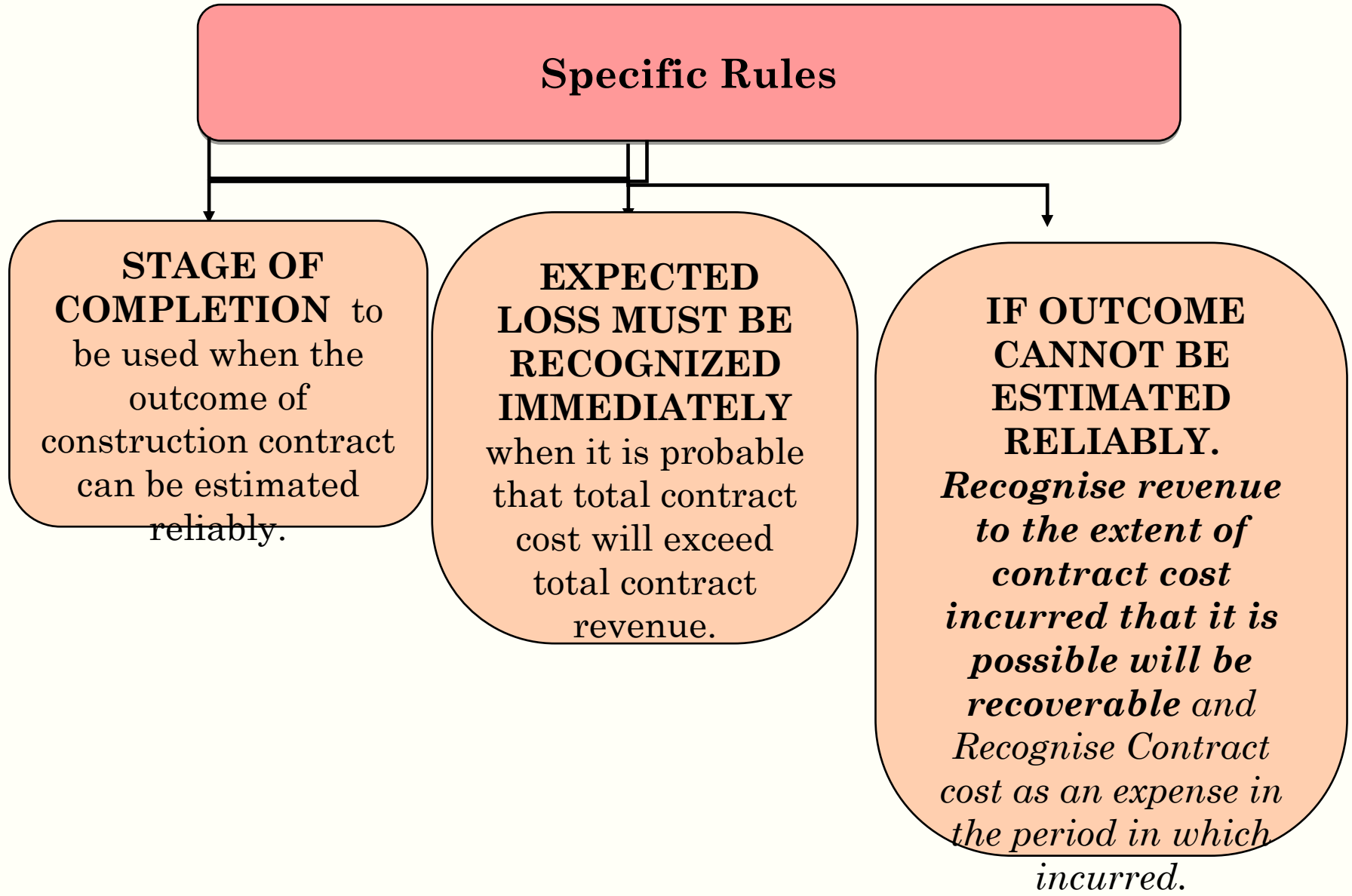
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graph TD; A["The rules in IAS 11 provides for three possibilities  
Arising on contract review"] --> B["Profits are expected  
and outcome is  
reasonably certain."]; A --> C["Loss is  
expecte  
d."]; A --> D["Outcome can be  
assessed with  
reasonable certainty"];
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Profits are expected
and outcome is
reasonably certain.

Loss is
expecte
d.

Outcome can be
assessed with
reasonable certainty

RECOGNITION & MEASUREMENT – CONTRACT REVIEW



Can be estimated reliably- Meaning

In case of **fixed price contract** the outcome can be estimated reliably when all following conditions are satisfied.

- **Total contract revenue** can be measured reliably.
- **Probable that the economic benefit** with the contract will flow to the entity.
- **Contract to completion and stage of contract completion** at the end of reporting period can be measured reliably.

Can be estimated reliably- Meaning

In case of **Cost price contract** the outcome can be estimated reliably when all following conditions are satisfied.

- **Probable that the economic benefit** with the contract will flow to the entity.
- Contract cost attributable to the contract whether or not specifically reimbursable can be clearly identified and measured reliably.

STAGE OF COMPLETION

A) Proportion of Cost incurred:
$$\frac{\text{Cost to date}}{\text{Total Estimated cost.}}$$

B) Survey of work performed:
$$\frac{\text{Work certified}}{\text{Contract Price}}$$

C) Physical Proportion completed:

Recognition of expected Losses...

The loss is determined and recognised irrespective of the following:

- Whether contract has **Commenced or not**.
- **The stage of completion.**
- The amount of **profit expected to arise on** other contracts not part of this single contract.

Construction Contract – Other Points

- **Amount billed by the contractor** for work performed ***need not be equal*** to recognised ***contract values***.
- **Retention money-** Amount retained i.e held back by the customer according to the terms agreed upon.
- **Advance-** Amount received from the customer before work is done.

Steps to obtain figure for SOCI

1

Calculate the total expected profit:

Contract Price

Less: Cost to date

Estimated Future Costs.

**Check whether the contract makes a profit
(else we have to provide for full anticipated loss)**

Steps to obtain figure for SOCI

2

Calculate Stage of Completion

Acceptable methods include

Sales basis

$$\frac{\text{Value of work done to date}}{\text{Total Sales}}$$

Cost basis

$$\frac{\text{Cost to date}}{\text{Total Cost}}$$

Steps to obtain figure for SOCI

3

Calculate REVENUE & COST for the year.

Calculate attributable revenue and costs to date.

**Deduct any Revenue and costs recognised in profit or loss
in earlier SOCI**

**If Profit cannot be prudently recognised, include same amount in
SOCI for both revenue and cost of sales to give a NIL profit.**

Calculation & disclosure of amount to be shown.

Example

	\$
Total contract price	200,000
Cost incurred to date	96,000
Estimated cost to completion	64,000

Progress Billing

(of this \$100,000 is received) 116,000

Percentage complete 60%

Required

Prepare relevant extracts from income statement and balance sheet.



Answer

Stage 1

Check whether the contract makes a profit:

(else we have to provide for full anticipated loss)

		\$
Total revenue		200,000
Total cost	(96,000+64,000)	160,000
Profit		40,000

Stage 2

Calculate % completion:

Given in this example

60%

Stage 3

Statement of comprehensive income

\$

Revenue 60% of 200,000 =

120,000

Costs 60% of 160,000 =

96,000

Profit

24,000

Stage 4

Statement of financial position

Gross amounts due from customers (part of current assets)

\$

Contract costs incurred

96,000

Add: Recognised profits-recognised losses

24,000

120,000

Less: Progress Billing

116,000

Amount due from customers

4,000

Trade receivables (current assets)

\$

Progress Billing

116,000

Less: Cash received

100,000

16,000

Presentation and Disclosure

An entity should disclose:

- The amount of **contract revenue recognised** as revenue in the period.
- The method used to **determine the contract revenue** recognised in the period.
- The methods used to **determine the stage of completion** of contracts in progress.

Presentation and Disclosure

An entity should disclose each of the following for the contracts in progress.

- The aggregate amount of costs incurred and recognised profits to date.
- The amount of advances received.
- The amount of retentions.

An entity should present:

- The gross amount due from customers for contract work as an asset.
- The gross amount due to customers for contract work as a liability.

Presentation and Disclosure

Gross amount due to or from customers is the net amount of:

- Cost incurred PLUS
- Recognised profits LESS
- Sum of recognised losses and Progress billings.

THANK YOU

CA NALIN SHARMA

nalinsharma31@gmail.com

9910792325